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THE FIRM, TAKE-OVERS, AND DIRECTORS' DUTIES: A THEORY OF THE FIRM AND THE DUTIES IMPOSED BY LAW ON THE DIRECTORS OF AN OFFEREE CORPORATION

by

Wayne Stanley Alford © ©

A thesis submitted to the Faculty of Graduate Studies and Research in partial fulfilment of the requirements for the degree of Master of Laws.

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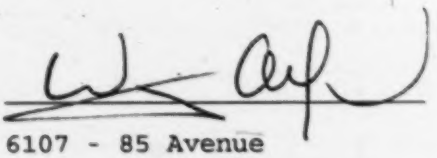

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The undersigned certify that they have read, and recommend to the Faculty of Graduate Studies and Research for acceptance, a thesis entitled "The Firm, Take-overs, and Directors' Duties: A Theory of the Firm and the Duties Imposed by Law on the Directors of an Offeree Corporation" submitted by Wayne Stanley Alford in partial fulfilment of the requirements for the degree of Master of Laws.

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Abstract

This thesis compares a financial model of the take-over process to the legal regime that constrains a target firm's board of directors. The financial model is developed in detail and the interests it values are determined. The law that constrains the target firm's board of directors is developed. The Alberta and federal regimes are analyzed in depth. The responses of the board to the take-over bid are divided into three categories: those that are required; those that may be made; and those that are prohibited. The final step of the analysis is a determination of whether or not the legal regime advances the interests valued by the financial model. It is concluded that the legal regime supports the efficient dissemination of information, but it is less supportive of the attributes of liquidity and alienability of shares. These interests are all valued by the financial model.

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CHAPTER 1

INTRODUCTION TO THE THESIS

INTRODUCTION

This thesis conducts a normative analysis of the law that constrains the actions of an offeree corporation's board of directors when an uninvited take-over bid has been received. Specifically, it examines how well those laws harmonize with the relevant financial model of the corporation.

The analysis begins in Chapter 2 with a review of the literature on the theory of the firm. From this review a prescriptive model of the firm is derived. Chapters 3 and 4 of the thesis review the law that imposes positive duties on the directors of a target firm to respond to an uninvited take-over bid. The federal and Alberta legal regimes are emphasized. The optional and prohibited responses are examined in Chapter 5. The thesis concludes with an analysis of how well the law has responded to the needs of the firm as represented by the prescriptive model derived in the thesis.

The thesis concludes that, in several regards, there is a lack of harmony between the law and the financial model. It also concludes that the law in this area is not, in all aspects, consistent with general corporate law doctrine, and

the thesis makes a recommendation for an alternative analysis.

There are significant segments of our legal system whose substantive content is based, in part, on financial theory. Securities law, bankruptcy and insolvency law, and tax law are three areas that have a conspicuous relationship to financial theory. This thesis looks at an aspect of securities law. It is a fundamental assumption of the thesis that financial theory has a direct impact on securities regulation. The *Kimber Report*, the seminal document of modern Canadian securities law, explicitly called for securities regulation to be brought into line with the underlying financial institutions and theories.[1] An appreciation of the theories and mechanisms that govern these institutions and the activities the law is attempting to regulate is a prerequisite to a comprehensive understanding of securities regulation. Unfortunately, though there are some exceptions within legal scholarship, little, if anything, is done to bring the disciplines of law and finance into sufficient discourse to facilitate this understanding. Training in one of these areas tends either to ignore the other (the legal approach) or to portray the other as a well-meaning but incompetent associate (the financial method).

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1. *Report of the Attorney General's Committee on Securities Legislation in Ontario* (the "*Kimber Report*") (Toronto: Queen's Printer, 1965)at paragraph 1.09 and 1.10.

Legal analysis has a strong tradition of legal positivism,[2] and it emphasizes the needs of the professional as a practitioner. In the practice of law perceptions of quality are based on results, they are not based on depth of analysis. The realities of professional practice constrain the time that can be expended on any issue. As a result, the relevant rules of law are subjected to only that amount of scrutiny required to represent the client's position. Legal education tends to reflect this reality and the expectation of law students that their education will be directed toward practical matters. Any attempt to bring theory from other disciplines into legal education is generally met with impatience and the twin inquiries: "will this be on the exam?" and "will I need to know this when I get into practice?"

Training in finance encourages students to treat the legal system as an exogenous variable.[3] For the most part the legal system can be relied upon to perpetuate suboptimal solutions to financial problems. The law also serves

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2. T. Honderich, T., ed., *The Oxford Companion to Philosophy* (Oxford: Oxford University Press, 1995) at 476:

> Legal positivism, ... denies any 'necessary connexion between law and morality'. Central these among a loose cluster: (1) law is definable and explainable without evaluative predicates or presuppositions; (2) the law ... is identifiable from exclusively factual sources (e.g. legislation, judicial precedents).

3. Exogenous variables are those factors affecting a system that are subject to change caused by influences arising outside of the system.

as a frequent source for entertaining anecdotes and examples of folly to illustrate points being made in lectures.

The thesis will explore, within a limited context, the interaction between these two disciplines. In this the analysis is explicitly pluralistic.[4] It is hoped that this effort will bring about a partial integration of finance and law and demonstrate that there is value in an analytical process that accesses substantive principles from sources external to the law.

Two activities were involved in the preparation of this thesis. One involved an investigation of the substantive issues at hand. The other involved the development of a process of analysis. The analytical process that was required for this project was one that could be applied to the specific aspects of securities law under consideration in this thesis and be applied in the future to other aspects of law. The first step in that analysis must be a consideration of how the financial theory interacts with the law.

In the thesis, finance and law are put together in a composite. The parts, while remaining discrete, interact. Each of the disciplines contributes to the outcome by performing a distinct function. Financial theory provides a model for a properly functioning financial sector. The law provides the framework within which this model can be

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4. *The Concise Oxford Dictionary of Current English* (1995), s.v. "pluralism" ... a theory or system that recognizes more than one ultimate principle. pluralistic *adj*.

erected and function. For the composite to operate efficiently[5] the law must be in harmony with the model provided by financial theory. There must, as well, be some mechanism by which the model informs the law of the properties which will characterize a properly functioning financial sector. It is assumed in the thesis that this process is facilitated by the financial model putting certain interests[6] forward for advancement in much the same way a software program passes parameters to functions. If the law, in turn, advances those interests, there is consistency and harmony between the legal regime and the financial model. The degree to which there is consistency will be considered reflective, though not determinative, of the quality of the law.[7]

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5. The concept of "efficiency" as it is used at this point is that which endeavours to produce the desired end product with the least amount of wastage.

6. The values that underlie the financial model could have been selected as the content of the communication between the parts of the composite. Interests were, however, selected because they are identified with discernible groups or individuals. Values, on the other hand, permeate the model but are not sufficiently attributable to groups or individuals to facilitate the analysis. This reflects my view that the law acts through its influence on the interests of groups and individuals and not by directly adjusting the values that underlie those entities' belief systems.

7. There may be numerous other considerations that bear upon the quality or appropriateness of the law. Other models of the corporation, for instance a political model, will demand that attention be paid to their content. The process adopted in this thesis is a heuristic and aid in understanding the law. It is not intended to be a comprehensive assessment of the law's appropriateness.

SCOPE OF THE THESIS

The primary question considered in the thesis is whether the laws that constrain the actions of the directors of a target corporation advance those interests which financial theory tells us should be advanced to ensure the efficient functioning of the take-over process. To facilitate this study the thesis looks at some of the theories of the firm that have been proposed by financial theorists. Special attention is paid to the theory of the firm developed by proponents of transaction cost economics.[8] Emphasis is

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8. The selection of the theory of the firm rather than specific models of the take-over process (see for example: K.S. Chung, S.E. Hoag & J.F. Weston, *Mergers, Restructuring and Corporate Control* [Englewood Cliffs, N.J.: Prentice Hall, 1990] pp. 659 *et. seq.*) was motivated by the latter's emphasis on the wealth distribution effects of take-overs and their lack of emphasis on the qualitative aspects of the environment within which the take-over proceeds. The quantitative emphasis in the take-over models renders them inappropriate for the type of analysis performed in the thesis. The analysis in the thesis is concerned with attributes of the economic institutions involved in the processes that control take-overs and the steps that must be taken to satisfy the duties imposed on directors by those processes. The wealth distribution models do not deal with these issues. Rather these models emphasize the financial decisions that precede the processes or the financial effects that follow those processes. They do not describe the institutions nor deal with the specifics of the control of the process.

The theory of the firm produced by transaction cost economics has been emphasized due, in part, to the depth of material available. The emphasis placed on the institutions of the economy and governance structures of transactions also make it an attractive complement for legal analysis. The choice of transaction cost economics is also supported by the analysis of J.A. Robbins, "Organizational economics: Notes on the use of transaction cost theory in the study of organizations" (1987) 32 Administrative Science Quarterly 68 at 80 wherein he states that, notwithstanding

(continued...)

placed on those aspects of the theory of the firm that affect the take-over process but not to the exclusion of the general features of the theory. The thesis will then analyze the regulatory scheme that governs the take-over process. That examination includes, amongst other issues, a consideration of the legal model of the corporation.

Throughout the thesis the theory of the firm and the legal model of the corporation are referred to as "models"[9] although the constructs considered do not strictly comply with the definition of model. The term is used in an intentionally open-textured manner. Because the models in question contain some elements that are idealized and not necessarily reflective of reality they are not restricted to a "map of limited aspects of reality."[10] They are Janus-like: they serve the dual functions of reflecting reality and proposing an ideal at the same time. They provide a degree of explanatory and predictive power, and they point to a better way of doing things. The dominant organizational

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8. (...continued)
shortcomings, transaction cost economics can help explore organizations once they have been defined.

9. Honderich, *supra*, note 2 at 582. Models are an attempt to map limited aspects of reality, introducing simplifying assumptions, which are adjusted or removed in the light of the model's predictive successes.

10. *Ibid.*

form of the firm is the corporation. As a result the terms "firm" and "corporation"[11] are used inter-changeably.

The thesis considers two distinct models of the corporation: the model that is provided by the discipline of finance and the model that underlies corporate law. The models perform different roles within the analysis. The financial model is used as the standard against which the legal regime is judged. It will, therefore, be the prescriptive model. The legal model is considered in its function as a part of the regulatory scheme. It influences and contributes to that scheme. It does not, for purposes of this thesis, represent a normative model.

These models are not identical. An important consideration is the tension created within the take-over process due to the use of these non-identical models of the corporation and the means by which the regulatory system resolves this lack of harmony. Under the current legal regime certain interests provided for in the legal model are discarded in the take-over process. The thesis considers changes to the regulatory system that will allow those interests to be considered throughout the take-over process while still avoiding conflicts.

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11. The subject matter of the thesis also contributes to the equation of firm and corporation. Take-overs controlled by the securities regime only affect corporations. Accordingly, it is the corporate form of firms with which this thesis deals.

The financial model attempts to summarize the attributes of the corporation as an economic entity, and it uses those attributes to explain the corporation's rise to economic dominance. In so doing, the model does not restrict itself to a summary of what is: it also considers what should be. These descriptions and explanations provide, either explicitly or implicitly, a normative model of the corporation. If the attributes of this model were realized, the corporation so formulated should function better than corporations that do not exhibit those attributes.[12]

The legal model of the corporation describes a control structure and a distribution of duties and powers intended to facilitate the proper working of a corporation. It reflects reality to the extent that legislation and judicial consideration follows its format. It represents an idealized corporation to the extent that legislation and judicial consideration do not adhere to its format. It is, nonetheless, treated in the thesis as a positive model of the corporation. Because it constitutes a facet of the regulatory regime under consideration, the appropriateness of the

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12. It is an assumption of the thesis, for purposes of developing the theory of the firm, that the take-over process is a normal or expected feature of the model of the firm and, therefore, is not a disturbance. See: O.E. Williamson, "Comparative economic organization: The analysis of discrete structural alternatives" (1991) 36 Administrative Science Quarterly 269, for a discussion of disturbances and their effect on governance structures.

interests promoted by the legal model will be considered in the context of the take-over process.

To accomplish this analysis the financial model will be described and discussed. An important question raised is, what interests does the financial model require the system to advance to ensure the proper functioning of the firm? Next, the regulatory regime that governs the conduct of a target firm's board of directors in the context of an uninvited take-over bid will be described and discussed. An important question raised is, what interests are in fact advanced by that regulatory scheme? The degree to which the interests advanced by the regulatory scheme match those that are held out as important by the financial model will determine the degree to which the regulatory scheme fits the financial model. A close fit is good. A loose fit requires a reconsideration of either the financial models or the law. The interests advanced should also be in accord with interests advanced by financial and legal doctrine of general application. It is not enough that the interests advanced only make sense within the context of a take-over. The interests must also be such that advancing them within the context of a take-over does not undermine the integrity of the legal and financial systems as a whole. It follows that a rule that advances a suitable interest within a take-over may not be an appropriate rule if it is contrary to doctrine applicable to other areas of corporate law or financial theory.

The financial model of the firm that is developed does not acknowledge the interests of the corporation *per se*. It considers the corporation as a surrogate in which the interests and claims of the shareholders and other constituents of the corporation reside. It has nothing of its own. If one removes the interests of the constituents there is nothing left within the corporation to be protected or advanced.

The legal model of the corporation does recognize interests of the corporation *per se*.[13] During the development of Canadian corporate law two models of the corporation have been used.[14] The first was the contractarian model which is used in English statutes.[15] This model was prevalent in Canada until the 1970s when, for the most part, it was replaced by the division-of-powers model.[16] This new model is based on American corporate statutes.[17] Both the old contractarian and the newer division-of-powers models

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13. Interests of the corporation and the corporation's claimants will be non-identical in circumstances of asymmetric information. That is, there is information about the corporation and its prospects that are not known to its shareholders or the market. This asymmetry will persist if the cost of communicating the data influence against its release.

14. B.L. Welling, *Corporate Law in Canada: The Governing Principles*, 2d ed. (Toronto: Carswell, 1991) at 37.

15. *Ibid.* at 54.

16. *Ibid.* at 38.

17. *Ibid.*

acknowledged the distinct and independent legal existence of the corporation.[18]

The legal models establish a separate legal status for the corporation, and, by implication, they must also contemplate the existence of rights and interests held by and for the corporation. The corporation will have rights and interests that do not flow through to the shareholders or others with claims against the corporation. An example of such rights is the corporation's right to freedom of expression.[19] In this thesis it is assumed that these rights and interests have a non-trivial value. They deserve to be respected and protected.

Corporations pervade our lives.[20] Controlling these organizations while allowing them sufficient freedom to advance the interests of their constituents and allowing society to enjoy the contributions made by corporations to society's overall well-being is an extremely complex task. The regulatory devices intended to control corporations are

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18. See for example: *Salomon* v. *Salomon & Co.*, [1897] A.C. 22 (H.L.) and the *Alberta Business Corporations Act*, R.S.A., 1980, c. B-15, as amended, ("*ABCA*") ss.1(n),9(1), & 15.

19. See for example: *National Citizens' Coalition Inc.* v. *A.G. Canada* (1984), 11 D.L.R. (4th) 482 (Alta. Q.B.).

20. For example, census information in 1966 showed that 65% of all retail transactions took place in stores owned by corporations. F.H. Leacy, ed., *Historical Statistics of Canada* (Ottawa: Statistics Canada, 1983) Series V314-319. This information is dated, and it is very likely that with the modernization of the corporation statutes in the 1970s the percentage is now higher.

not always developed in harmony with other pre-existing or developing regulations. The regulatory devices are not always in full accord with the functions they were intended to perform. This lack of accord can lead to conflict and inefficiency. By examining the substantive models of the activities a regulatory scheme is attempting to regulate and comparing those models to the regulations and their effects, areas that may lead to tension can be highlighted. Better ways may be found to advance the appropriate interests and bring the regulations into closer accord with the underlying processes. The take-over process is one such area that can be subjected to this form of examination.

The take-over process is principally a financial process. Financial theory calls for the market to make the final decision as to whether or not a take-over is appropriate.[21] The relevant financial theory assumes that an offeree will be aware of an opportunity to act.[22] It assumes that, if the offeree shareholders have all the information they require to assess their choices, they will make a rational decision. It also assumes they can act on that choice.[23] Through this process the market can and does arrive at the most societally optimal allocation of financial resources.

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21. M.R. Gillen, *Securities Regulation in Canada* (Scarborough, Ont.: Carswell, 1992) at 63.

22. *Ibid.*

23. *Ibid.*

The law should provide the environment in which a properly functioning take-over process can operate. To do so the law should advance the interests that the financial model indicates should be advanced. The financial model prizes shareholder liquidity and the free allocation of financial resources through the use of market mechanisms.[24] That is, *inter alia*, the financial model indicates that shareholder interests should be advanced.[25] The shareholders' ability to alienate their shares on such terms and at such time as they see fit, without interference by the target firm's board of directors, and their ability to access material information are particularly important. Take-over defences that terminate the take-over process or severely restrict shareholder access to the bid are inconsistent with the financial model. Such actions interfere with the shareholders' interests in alienation and distort or frustrate the financial allocation role of the take-over process. These defences also undermine certain conditions

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24. *Ibid.*

25. These interests can be advanced through a number of devices. Information which is needed but not yet available can be released. Access to bidders can be enhanced, and steps that can be taken by others that interfere with the interests of the shareholders can be ameliorated or prohibited.

that are required to promote an active and growing capital market.[26]

When shares are purchased, purchasers may have been influenced in their decision to buy by the chance that a take-over would occur. Such a belief could influence the price paid, the decision to buy, or both. Take-over defences established and executed after the purchase of shares will frustrate the expectations of the investor.

If an investment is liquid,[27] the return that must be paid to induce investment is less than that which must be paid for an illiquid investment.[28] If liquidity is reduced the cost of capital increases. Take-over defences reduce liquidity, and they therefore, other things remaining equal, increase the cost of capital.

The directors of a corporation owe a fiduciary duty to the corporation to act in a manner that advances the best interests of the corporation.[29] In the context of a take-over bid, the judgements of various courts have imposed an additional duty on the board of directors to act in the best

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26. Gillen, *supra*, note 21 at 64: the promotion of confidence in financial markets is not helped by actions such as take-over defences that distort the market.

27. Liquidity denotes an ability to sell the asset without considerable price consequences or delay.

28. Y. Amihud & H. Mendelson, "Liquidity and stock returns" (1986) Financial Analysts Journal (May-June 1986) 43.

29. See for example: *ABCA*, s.97(1).

interests of the shareholders as a whole.[30] This duty has a long history, but the thesis raises doubts about its pedigree. Its imposition has had an effect on the legal regime. Its existence has moved the legal regime into a position that is more in accord with the financial model of the take-over process than the regime would be without it.

Has the integrity of the legal model been compromised by this added duty? Does the fact that this apparent breach puts the two models into closer harmony excuse the breach? Could harmonization have been achieved without this breach? The thesis presents an alternative legal analysis that will be faithful to the interests being advanced by the existing process, but it will do so in a manner that does not require the displacement of corporate law principles of general application.

Take-over defences, such as poison pills, are not consistent with the financial model. Under the alternative analysis these defences are eschewed. Directors of corporations whose long-term value is not reflected in the market price of the firm's securities must find means other than take-over defences to protect that value and the interests of the corporation. This can be accomplished by provisions in the corporate constitution that make it difficult to take over the corporation and that are known to investors before

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30. *Teck Corporation* v. *Millar* (1972), [1973] 2 W.W.R. 385, 33 D.L.R. (3d) 288.

they invest in the firm's securities. Improved communication of the corporation's plans and the value of those plans will also assist. The use of a "*status quo* offer" that advocates, with passion and enthusiasm, a hold-your-shares response to the take-over bid is another potential response to the take-over bid. It is the board's job to convince the market that the shareholders' profit maximization is best served by leaving the corporation as it is. The take-over process should facilitate this function rather than protecting long-term corporate interests through interference with the shareholders' rights.

The take-over process performs important functions in financial theory. The process also occupies a conspicuous and important place in daily business practices.[31] The existence of the take-over processes disciplines directors and management,[32] and it facilitates the allocation of financial resources to endeavours that the markets consider of higher value from those the market views as being of

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31. In 1996 Canadian firms were involved in 1,185 mergers and acquisitions which was a 20% increase from 1995. The value of the 1996 activity was $75.3 billion. This amount was just below the record value of activity in 1995. These amounts dwarf the activity in 1989 after adjusting for inflation. K. Kidd, "Year of the deal", *The Globe and Mail Report on Business Magazine* (July, 1997) 53 at 54.

And at 57: The first quarter of 1997 saw 327 deals worth $24 billion. This is an increase from 251 and $22 billion in 1996.

32. R.A. Posner, *The Economic Analysis of Law*, 4th ed. (Boston: Little Brown, 1992) at 412.

lesser value.[33] The regulations that affect the directors of a target corporation are very important because of the important role played by these directors in a take-over and the potential they have to indulge in self-interest seeking behaviour.[34] The directors control access to much of the important information required by the market. They can, within constraints, pursue take-over defences that may thwart, or at least distort, the financial resource allocation processes of the take-over. The important role played by the directors and the regulatory scheme's treatment of the interests valued by the financial model are, therefore, important aspects of the take-over process.

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33. *Ibid.*

34. The first Canadian poison pills were introduced in 1988 by Inco Limited and Pegasus Gold Inc. J.A. Millard, *The Responsible Director* (Calgary: Carswell,1989) at 82 and 84.

Litigation has been pursued to test the allegation that the directors of corporations have adopted these defences for reasons other than the best interests of the target's security holders. Gillen, *supra* note 21 at 334-338.

There are two explanations suggested for the existence of poison pills. There is the shareholders' interest hypothesis that stresses the role played by poison pills in protecting the interests of shareholders. And there is the managerial entrenchment hypothesis that stresses management's desire to retain their positions within the firm as the motivation behind take-over defences. J.G. MacIntosh, "The poison pill: A noxious nostrum for Canadian shareholders" (1989) 15 *Canadian Business Law Journal* (1989) 276 at 278.

At 298: MacIntosh notes that evidence from studies of share price reactions is highly consistent with the managerial entrenchment hypothesis.

REGULATORY REGIMES TO BE CONSIDERED

Both the Alberta and the federal regulatory regimes are considered at length in the thesis. Ontario, British Columbia, and Alberta are the leading financial jurisdictions in English Canada. Because of the high degree of similarity between the provincial regimes, an analysis of the Alberta system with footnotes to the British Columbia and Ontario regimes will give a full appreciation of the provincially regulated take-over system within Canada.

The federal jurisdiction is considered because many of the firms that operate throughout Canada are incorporated under the *Canada Business Corporations Act*, R.S.C., 1985, c. C-44, as amended, ("*CBCA*"). The *CBCA* contains a limited scheme of securities regulation, and it is applicable whenever the target firm in a take-over bid is a *CBCA* corporation.[35] The *CBCA* requirements will, therefore, affect the conduct of the target firm's board of directors, and, it follows, that an understanding of the requirements of this statute is important to an appreciation of the take-over regime.

STRUCTURE OF THE THESIS

Chapter 2 of the thesis consists of a review and examination of the theory of the firm. In particular it deals with the theory of the firm found in the literature on

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35. *CBCA*, ss.2, & 194.

transaction cost economics. It considers the nature of the firm, why the corporation is the organizational form of choice, why equity is the preferred means of financing corporations, the nature and implications of corporate governance, and a description of the legal model of the firm.

Chapter 3 is an examination of the statutory control of the take-over process in Alberta. That chapter is concerned with the responses the target firm's board of directors must make upon receipt of an uninvited take-over bid. The effects of the *Alberta Business Corporations Act*, R.S.A., 1980, c. B-15, as amended, ("*ABCA*"), the *Securities Act*, S.A., 1981, c.S-6.1, as amended, ("*ASA*"), and the lesser regulatory instruments that govern the take-over process in Alberta are considered. Special attention is paid to duties of disclosure.

Chapter 4 deals with the effect of the *CBCA* on the take-over process. As with Chapter 3, the focus of the chapter is on those responses which the board of directors must make to the take-over bid. How the incorporation procedures and the take-over bid provisions of the Act affect the take-over process are examined. The duties imposed on the target firm's directors and their burden of disclosure are emphasized.

Chapter 5 looks at the law that affects the decisions of the target firm's board of directors on whether or not to

utilize optional responses (in particular take-over defences) to the take-over bid. It also deals with responses that are prohibited, completes the analysis, and provides conclusions as to the appropriateness of the legal regime in light of the financial theory of the firm.

CHAPTER 2

THE THEORY OF THE FIRM

INTRODUCTION

This chapter deals primarily with the theory of the firm. It considers why people organize certain of their economic activities within firms; why the corporation is the dominant form of the firm; why equity is such an important means of financing corporations; how the separation of ownership and control affect the functioning of the corporation; and the role played by the take-over process. When these matters have been discussed and developed a prescriptive model of the firm will be derived. In turn, the interests which the model values will be determined. The chapter concludes with an examination of the legal model of the corporation.

The interests valued by the derived model are those that the legal regime should advance if that regime is in harmony with the prescriptive model. It follows that the contents of this chapter are fundamental to the analysis conducted in the thesis.

THE THEORY OF THE FIRM

Business is to a large extent conducted by firms. The most common manifestation of the firm is the corporation. This form of economic organization is remarkably adaptable. The same organizational form functions as well for a one-person sales business as it does for an international conglomerate. When we speak today of firms we are chiefly discussing corporations. There are, however, other forms of business organization in use, and they too are firms. Partnerships dominate in the provision of services in the legal and accounting professions. Co-ops perform well in many agricultural settings. Sole proprietorships still exist. Far and away, though, the most popular form of business organization and the best example of the firm today is the corporation.

Various theories have been advanced to explain why firms exist and why they function as they do.[1]

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1. Professor B.R. Cheffins combines attributes from different theories, some of which will be examined below, into a single explanation of the firm. This is a useful means to present an analysis of the firm, but it is of limited assistance for the prescriptive role required for this thesis. B.R. Cheffins, *Company Law: Theory, Structure and Operation* (Oxford: Clarendon Press, 1997) at 31-47.

Transaction Cost Economics[2]

Background

Transaction cost economics and its methods of analysis find their roots in R.H. Coase's 1937 work,[3] and they have received considerable attention since the publication by O.E. Williamson of his 1975 book, *Markets and Hierarchies*.[4] Williamson's work, due to his influence and the volume of his contributions, forms the foundation for the review that follows.[5]

Transaction cost economics studies the economic institutions of capitalism.[6] It recognizes three capitalistic

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2. Notwithstanding the emphasis that this thesis places on the transaction cost economics analysis of the firm, this analysis is not without its critics. Examples of that criticism will be given throughout the discussion that follows.

3. R.H. Coase, *The Firm, the Market, and the Law*, (Chicago: University of Chicago, 1990) at 33.

4. O.E. Williamson, *Markets and Hierarchies* (New York; Free Press, 1975).

5. G.K. Dow, "The function of authority in transaction cost economics" (1986) 8 Journal of Economic Behaviour and Organization 13 at 14.

6. O.E. Williamson, "Transaction cost economics" in R. Schmalensee & R.D. Willig, eds., *Handbook of Industrial Organization*, Vol. 1 (New York: North Holland, 1989) 135 at 136.

institutions: firms, markets and hybrid modes.[7] The research objective of this type of study is:

> [T]o organize our necessarily incomplete perceptions about the economy, to see connections that the untutored eye would miss, to tell plausible ... causal stories with the help of a few central principles, and to make rough quantitative judgments about the consequences of economic policy and other exogenous events.[8]

Transaction cost economics analyses the contractual relationships between the resources and parties involved in human enterprises,[9] and it considers the variety of institutions in the economy.[10] Each of these institutions displays different characteristics.[11] Transaction cost economics looks for a common theory of contract that will explain all of these institutions, and if that common theory exists, it endeavours to disclose the characteristics of that theory.[12]

> As compared to other approaches to the study of economic organization, transaction cost economics (1) is more microanalytic, (2) is more self-con-

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7. *Ibid.*; *Idem.*, "Comparative economic organization: the analysis of discrete structural alternatives" (1991) 36 Administrative Science Quarterly 269 at 270. In the "Comparative" article Williamson lists public utility regulation, exchange agreements, and franchising arrangements as examples of the hybrid mode of capitalistic institutions.

8. R. Solow, "Economic history and economics" (1985)75 American Economic Review 328.

9. Williamson, "Transaction cost economics", *supra* note 6 at 136.

10. *Ibid.*

11. *Ibid.*

12. *Ibid.*

> scious about its behavioral assumptions, (3) introduces and develops the economic importance of asset specificity, (4) relies more on comparative institutional analysis, (5) regards the business firm as a governance structure rather than a production function, (6) places greater weight on the *ex post* institutions of contract, with special emphasis on private ordering (as compared with court ordering), and (7) works out of a combined law, economic and organization perspective. The basic transaction cost economics strategy for deriving refutable implications is this: assign transactions (which differ in their attributes)to governance structures (the adaptive capacities and associated costs of which differ) in a discriminating (mainly transaction cost economizing) way.[13]

The Core Concepts

The main case of transaction cost economics is that "...economizing is the core problem of economic organization."[14] This body of literature views the economic person differently from the view held by mainstream economics:

> ... [C]ontracting man is distinguished from the orthodox conception of maximizing man in two respects. The first of these is the condition of bounded rationality. Second, contracting man is given to self-interest seeking of a deeper and

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13. *Ibid.*

14. *Ibid.* at 137. See also: *idem.*,"Transaction cost economics the comparative contracting perspective" (1987) 8 Journal of Economic Behaviour and Organization 617 at 618. This article was written, in part, as a response to Dow, *supra* note 5. In it Williamson, at page 618, questions whether Dow sees the main case of economic organization not as economizing but rather as exploitation of workers.

more troublesome kind than his economic man predecessor.[15]

Transaction cost economics accommodates the limited knowledge and intellect of human actors, and self-interest seeking behaviour which includes guile and obfuscation that is calculated to confuse.[16] It is concerned with contractual relationships, and the attributes that govern the forms of feasible contracting relationships. The feasible set of contracting relationships will exclude both the impossibly complex and hopelessly artless forms of contracting.[17]

The idea that humans have limited knowledge and intellect is summarized within the concept of bounded rationality.[18] Bounded rationality precludes comprehensive *ex ante*[19] contracting. All contracts within the feasible set are, as a result, incomplete.[20] Accordingly, the *ex post*[21] side of the

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15. *Ibid.* "Transaction cost economics" at 138. See also: Cheffins, *supra* note 1 at 4 for a description of the "rational actor" from economic theory.

16. *Ibid.* "Transaction cost economics", at 139.

17. *Ibid.*

18. *Ibid.* See also: *idem.*, "Opportunism and its critics" (1993) 14 Managerial and Decision Economics 97 at 97.

19. *The New Shorter Oxford English Dictionary* (1993) s.v. "ex ante":... *adv. phr.* Before the event, in advance, beforehand. The expression is also used as an adjectival phrase. Cf.: *ibid.* ... *adj. phr.* Based on prior assumptions or expectations; predicted, prospective.

20. Williamson, "Transaction cost economics", *supra* note 6 at 139.

contract has special economic significance to transaction cost economics. Structures that deal with the resolution of difficulties arising *ex post* are vital to the transaction cost economics analysis of economic organizations.[22] An example of such a structure is binding arbitration that resolves issues of contract extras following the completion of a construction contract.

Transaction cost economics rejects the assumption that economic actors will reliably fulfil their promises.[23] By accepting and accommodating opportunism, it emphasizes the importance of *ex ante* efforts to screen out unreliable contractors.[24] "Opportunism corresponds to the frailty of motive 'which requires a certain degree of circumspection and distrust' in the transaction cost economics scheme of things."[25] *Ex post* institutions that deter self-interest

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21. (...continued)
21. *The New Shorter Oxford Dictionary* s.v. "ex post" ... *adj. phr.* Based on events or actual results; occurring afterwards; actual rather than predicted; retrospective. The expression is also used as an adverb phrase. Cf.: *ibid.*, ... After the event; retrospectively.

22. Williamson, "Transaction cost economics", *supra* note 6 at 139.

23. *Ibid.* at 140.

24. *Ibid.*

25. Williamson, "Opportunism", *supra* note 18 at 97. But see: K. Cartier, "The transaction costs and benefits of the incomplete contract of employment" (1994) Cambridge Journal of Economics 181 at 184. Cartier questions the degree to which opportunism affects the work place while Dow *supra* note 5 at 20, questions the apparent lack of analysis of opportunism by managers in transaction cost economics literature.

seeking behaviour also take on greater significance.[26] The reputation of a firm for fair or harsh dealing will be an important factor in efforts to smooth the contracting relationship and thereby reduce transaction costs. This proposition finds corroboration in the literature on quality uncertainty, brand names and market mechanisms.[27]

Transaction cost economics uses transactions as the basic units of analysis. Attention can, therefore, be focused on:

> ... [T]he economizing efforts that attend the organization of transactions - where a transaction occurs when a good or service is transferred across a technologically separable interface. ... With a well-working interface, as with a well-working machine, these transfers occur smoothly.[28]

The goal is to execute the transaction with a minimum of transaction costs. Transaction costs are, in effect, the friction in the economic machine.

> Transaction cost analysis entails an examination of the comparative costs of planning, adapting, and monitoring task completion under governance structures.[29]

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26. *Ibid.* "Opportunism".

27. See: G.A. Akerlof, "The market for 'lemons': Quality uncertainty and the market mechanism" (1970) 84 Quarterly Journal of Economics 488; R.P Beatty & J.R. Ritter, "Investment banking, reputation, and the underpricing of initial public offerings" (1985) 15 Journal of Financial Economics 213.

28. Williamson, "Transaction cost economics", *supra* note 6 at 142.

29. *Ibid.*

Transactions will differ from one another. Different transactions are assigned to different governance structures in a manner that reduces costs.[30] A specific transaction may best be handled in a market setting (such as the market for accountants) or within a firm (using in-house accountants). It is expected that transactions will be conducted within the governance structure that provides the lowest level of transaction costs for that type of transaction.[31] If there are cost savings that can be achieved by accessing the market, the transaction is likely to take place in the market. An example of such a transaction is the purchase of newsprint in the spot market. If there are transaction costs

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30. *Ibid.* See also: *idem.*, "Comparative economic organization", *supra* note 7. In the "Comparative" article, Williamson refers to this allocation as the discriminating alignment hypothesis. And at 280 he states that markets and hierarchies are polar modes with hybrid modes occupying an intermediate position on the spectrum of governance structures.

31. Dow, *supra* note 5 at 17. The costs of the different governance structures are to be considered while holding the nature of the transaction fixed. And at 18-19:

> In short, governance structures are judged by their capacity to produce a 'better' transaction, in the potential Pareto improvement sense. Clearly transaction costs cannot be assessed only by examining the inputs used to support the decision process, as this would yield the trivial (and incorrect) conclusion that less governance is always better.

Dow, however, points out that there is a problem with this approach. That is, a better transaction must in someway be a different transaction. This in turn necessitates a distinction between the "details" of the transaction, which will change with a variation in the governance structure, and its "general" features which do not change.

savings to be achieved by bringing the transaction in-house, the transaction is likely to be conducted within the firm. In this way a firm is built by gathering together transactions that are most efficiently done in-house.

Factors That Affect the Choice of Governance Structure

Three dimensions are used to describe transactions: asset specificity; the degree and type of uncertainty affecting the transaction; and the frequency of occurrence (contract transformation).[32]

Asset specificity refers to the ability of an asset's owner to use the asset for other purposes, or to transfer the asset to other users, without a reduction in its value.[33] Asset specificity includes, but is not limited to, site specificity, physical asset specificity, human asset specificity, dedicated assets, and brand name capital.[34] The choice of an appropriate governance structure varies with each type of asset specificity.[35]

There are two types of uncertainty with which economic organizations must deal: primary uncertainty, which is state-contingent; and secondary uncertainty which arises

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32. Williamson, "Comparative economic organization", *supra* note 7 at 281.

33. *Ibid.*

34. *Ibid.*

35. *Ibid.* at 285.

"from lack of communications, that is, from one decision maker having no way of finding out the concurrent decisions and plans made by others."[36] Secondary uncertainty is "... at least as important as primary uncertainty arising from random acts of nature and unpredictable changes in consumer preferences."[37] This version of secondary uncertainty is rather benign. It does not consider the effects of intentional failure to communicate. Contracting relationships and asset specificity give rise to situations of bilateral dependency and, as a result, a third variety of uncertainty arises, that is, behavioral (binary) uncertainty.[38]

The *ex ante* contracting process is greatly affected by the number of qualified bidders that are involved. In contracts dealing with ongoing relations, a large number of bidders at the initial stage does not ensure that at the time of contract renewal there will still be a large number of bidders. Whether there is or is not a monopolistic situation *ex post* depends upon the degree to which the original supplier had to make durable investments in specific assets.[39] If they made such investments, the initial winning bidder will have an advantage over others at

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36. T. Koopmans, *Three Essays on the State of Economic Science* (New York: McGraw-Hill, 1957).

37. *Ibid.* at 162-163.

38. Williamson, "Transaction cost economics", *supra* note 6 at 143.

39. *Ibid.* at 144.

renewal. If not, the initial winner will not have an advantage. When this is the case, who one is contracting with becomes an issue with economic consequences. Bilateral dependency creates a positive incentive on the part of the contracting parties to work out the terms of an efficient, ongoing relationship rather than to terminate their relationship due to problems arising within the relationship or the need to renew the contract.[40] This consideration has a significant effect on the governance structure chosen for the transaction.

In general, the existence of asset specificity and uncertainty combine to create three categories of contracts.[41] The first are those contracts that involve the use of general purpose assets. These contracts require no protective governance structures. The lack of transaction specific assets allows market based contracting and efficient competition.[42]

The second category includes those contracts involving significant investments in transaction-specific assets

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40. *Ibid.* at 145. It has been suggested and demonstrated that this analysis is flawed in that it assumes a symmetric dependence between buyer and seller. There are differing patterns of symmetry with different types of assets and asset specificity, and there can be dependence without transactions specific assets. B. Nooteboom, "Research note: An analysis of specificity in transaction cost economics" (1993) 14 Organizational Studies 443 at 450.

41. *Ibid.*, "Transaction cost economics", at 147. See also: *idem.*, "Opportunism", *supra* note 18 at 100.

42. *Ibid.*, "Transaction cost economics".

without safeguards.[43] The parties effectively enter into a situation of bilateral trade. There are disincentives to either side to terminate the relationship. The break-even price for the supplier is high due to risk that arises due to the lack of safeguards. Transactions with these characteristics are generally unstable over time. They will either change, through time, into a situation where general application assets replace transaction specific assets, or safeguards will be added to encourage the continued use of transaction specific assets.[44]

The third category of contract contains those contracts that use transaction specific assets and have safeguards.[45] Because of the existence of safeguards, the risk associated with contracts in thes category is reduced and accordingly the price is reduced.

All three elements are linked. Price, asset specificity and safeguards affect one another. All three affect the selection of the appropriate governance structure. The *ex ante* terms and the manner in which subsequent contracts are negotiated vary with the investment characteristics and the choice of governance structures for the transactions.[46] To fully understand the transaction and devise an appropriate

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43. *Ibid.*

44. *Ibid.*

45. *Ibid.*

46. *Ibid.*

governance structure, the entire contracting process must be examined.

Measurement Problems

Measurement problems begin with the problem of information impactedness.[47] Information is either asymmetrically distributed between the parties, and it is very costly to equalize the distribution, or it is too costly to instruct an arbiter of the true information in the event of a dispute between exploitive parties who have identical knowledge of the underlying situation.[48] As with asset specificity, different measurement problems result in different solutions.

Team organization problems can be handled by supervision. Agency problems may result in incentive arrangements. And quality uncertainty might lead to a reputation effect response.[49] There is an intimate relationship between the governance structure chosen for the transaction and the problems that are inherent in the nature of the transaction.

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47. *Ibid.* at 149. *Cf.* The element of information impactedness is an earlier version of the concept of asset specificity. E.J. Englander, "Technology and Oliver Williamson's transaction cost economics" (1987) 10 Journal of Economic Behaviour and Organization 339 at 345.

48. *Ibid.*, "Transaction cost economics".

49. *Ibid.*

Market or Firm

Classic theories dealing with the organization of firms and markets held that the efficient boundaries of the firm were dictated by technology.[50] This concept was challenged by Coase. He posed another question: "When do firms choose to procure in the market and when do they produce their own requirements?"[51] He argued that the choice is determined by comparative transaction costs. The governance structure that results in the lowest transaction costs will be the one selected. But why are the transaction costs different in different structures?[52]e To understand how the transaction costs will differ between the market and internal organizations we should first look at how the institutions differ.

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50. *Ibid.* at 150. See also: Englander, *supra* note 47 at 344:

> Transaction-cost analysis supplants the usual preoccupation with technology and steady-state production (or distribution) expenses, with an examination of the comparative costs of planning, adapting, and monitoring task completion under alternative governance structures.

51. *Ibid.*, "Transaction cost economics". This question arises from Coase, *supra* note 3 at 33, wherein he poses the question and answers it with the assertion that it is transaction costs that determines the functions that firms do and do not perform internally.

52. *Ibid.*, "Transaction cost economics".

Markets promote "high powered incentives"[53] and restrain "bureaucratic distortions" more effectively than internal organizations. On occasion markets can aggregate demand and achieve economies of scale. Internal organizations, on the other hand, have access to far more adaptable governance instruments.[54] Markets favour tight cost controls, but they respond more slowly, if at all, to the changes required by the parties as bilateral dependency increases. Internal organizations can, if the resolve is there, respond appropriately to the changes imposed by increasing bilateral dependency. Consequently, the market will be the preferred source of inputs where there is a low degree of asset specificity. There is no need to produce it in the firm if you can use readily available general purpose assets. Internal supply will be preferred where asset specificity is great. This simple decision rule contains the assumption that economies of scale and scope are immaterial. This is an unrealistic assumption. The issue of production costs must, in reality, be considered in determining whether

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53. Williamson, "Comparative economic organization", *supra* note 7 at 275:

> As compared to markets, internal incentives in hierarchies are flat or low-powered, which is to say that *changes in effort expended have little or no immediate effect on compensation*. [emphasis added]

High powered incentives are those incentives which lead to large and immediate effects on compensation result when changes in effort expended have been made.

54. Williamson, "Transaction cost economics", *supra* note 6 at 150.

to obtain the input from the market or internally.[55] The firm will always be at a production cost disadvantage to the market, it follows that the firm will never integrate simply for production costs savings. It is the transaction cost savings that justify the decision to produce rather than to procure. Larger firms can achieve greater economies of scale for diverse inputs than can small firms, therefore, large firms will bring a greater number of inputs in-house than will small firms.[56]

Optimal Firm Size

Optimal firm size is an alternative theory of the firm. It suggests that the main issue facing those who organize economic activity is the determination of the optimal firm size.[57] At issue is how many of the firm's inputs are to be internalized in contrast to how many are to be obtained through separate contracts in the market. The choice to organize within the firm is determined by two types of costs: the costs of negotiation of each contract; and the countervailing costs of internalization.[58]

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55. *Ibid.*

56. *Ibid.* at 154.

57. F.H. Buckley & M.Q. Connelly, *Corporations Principles and Policies*, 2d. ed., (Toronto: Emond Montgomery, 1988) at 20. See also: Cheffins, *supra* note 1 at 36.

58. *Ibid.*, Buckley, at 21.

The costs attached to the negotiation of each contract can be reduced through empowerment of a managerial group to make decisions through time rather than trying to negotiate a completely contingent contract.[59] The firm itself is the source of the countervailing costs. These costs sort out into two categories: costs that are incurred due to the loss of information about commodity prices that would be provided if the competitive markets were used for supply; and the agency costs incurred to monitor and control self-interest serving behaviour by managers and other claimants. Were it not for these countervailing costs, it is conceivable that all economic activity would be brought into the firm to the annihilation of the market.[60]

Production Cost Efficiency

Another theory of the firm is the production cost efficiency theory. This theory holds that whether a production function will be brought in-house or will be handled in the market depends on scale economies of management and production, as well as transaction costs.[61] In addition, there may be reasons to bring production in-

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59. *Ibid.*

60. *Ibid.*

61. K.S. Chung, S.E. Hoag & J.F. Weston, *Mergers, Restructuring and Corporate Control* (Englewood Cliffs, N.J.: Prentice Hall, 1990) at 32.

house notwithstanding positive management costs where transaction costs are low.[62]

Team production and a centralized agent in the contractual relationships for all inputs are the characteristics that distinguish the firm. Team production results in a synergistic effect. The team will continue if its output is sufficiently higher than the independent output of its members that it offsets the costs of organization and monitoring.[63]

This centralized agent and the team provide informational advantages. The likelihood of the firm's success will be enhanced if the central agent has superior knowledge of the relative productivity and interaction of the team's members. The team, on the other hand, acquires information on the other members of the team and on the firm that enhances productivity. These information assets result in a positive cost to team members if they leave the firm. As a result, the existence of the informational assets motivates both the central agent and the team member to make specific long-term commitments to the firm.[64]

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62. *Ibid.*

63. *Ibid.*

64. *Ibid.* at 33.

Nexus of Contract

This theory of the firm holds that the firm is nothing more than the nexus of all the consensual and non-consensual claims that are held against the firm.[65] There are no insiders, and there are no outsiders, and there is no purpose served in trying to determine who the owners are.[66] The theory focuses on the terms by which each class contributes to joint production and how wealth maximization for all concerned can be achieved. As a consequence, this theory blurs the distinction between the firm and market:

> *The firm is not an individual*. It is a legal fiction which serves as a focus for a complex process in which the conflicting objectives of individuals (some of whom may "represent" other organizations) are brought into equilibrium within a framework of contractual relations. [emphasis in original][67]

These alternative theories that have been presented do little to assist the analysis that follows. The following

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65. *Ibid*. See also: Cheffins, *supra* note 1 at 31-32.

66. *Ibid*., Chung. The concern over which participants will be considered part of the firm and which will be treated as external to the firm is also found in accounting theory. There are two competing views: the proprietary view and the entity view. The proprietary view treats the firm and its owners as if they were a single entity and the creditors and other claimants as outsiders. The entity view treats the firm as an entity separate from all stakeholders. R.M. Skinner, *Accounting Standards in Evolution* (Toronto: Harcourt Brace & Company, 1987) at 42.

67. M.C. Jensen & W.H. Meckling, "The theory of the firm: managerial behavior, agency costs and ownership structure" (1976) 3 Journal of Financial Economics 305 at 311.

discussion will, therefore, rely on the transaction cost economics model.

TRANSACTION COST ECONOMICS AND THE THEORY OF THE FIRM

There are three capitalist institutions in which a transaction can be executed. It can be executed in the market, in a firm, or in a hybrid organization. Hybrids represent special cases, such as franchises, and in the interest of keeping this discussion general, only firms and markets will be dealt with. Though not explicitly stated, transaction cost economics appears to assume that the market holds the entire set of available transactions.[68] If conditions dictate, the firm will internalize a sub-set of those transactions. The market still has the potential to handle these transactions, and it remains a source of last resort if internalization fails.

Transaction cost economics predicts that transactions most efficiently conducted internally will be conducted internally. Those most efficiently conducted in the market will be conducted in the market. Applying this decision rule to the effort to delineate an orthodox theory of the firm, a transaction cost economics based theory can be articulated.

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68. The reliance of transaction cost economics on the assumption that a decentralized market structure is the natural organization of exchange has been criticized. J.A. Robins, "Organizational economics: Notes on the use of transaction cost theory in the study of organizations" (1987) 32 Administrative Science Quarterly 68 at 74.

The firm exists within the feasible contract set which is, in turn, a sub-set of the feasible transaction set. The firm is bounded by the transaction set defined as those transactions that can be most efficiently conducted internally. If transaction costs are lower for in-house production than for market procurement, the input will be produced in-house. It follows that, in the transaction cost economics theory of the firm, a firm exists where there is a gathering of transactions that are most efficiently handled internally. The firm produces those inputs, and the market produces all others. The firm is an economic structure that performs the function of reducing the transaction costs of certain transactions.

There are restraints on the operation of this decision rule. The cost of production cannot be ignored, and there may be insufficient will on the part of the business organization to make the accommodation required to internalize a transaction. Subject to these concerns, the decision rule is intuitively and logically attractive.

The reduction of costs for internalized transactions can be achieved by transaction specific governance structures or by the general structure of the firm. The firm is not restricted in its organizational form. It may be a partnership, a co-operative or a sole proprietorship. It may or may not be incorporated. It is, as stated above, simply a

gathering of transactions that are more efficiently executed internally than in the market.

THE CORPORATION: ORGANIZATIONAL FORM OF CHOICE

> ... [T]he modern corporation may be regarded not simply as one form of social organization but potentially ... as the dominant institution in the modern world. ... The law of corporations, accordingly, might well be considered as a potential constitutional law for the new economic state, while business practice is increasingly assuming the aspect of economic statesmanship.[69]

The theory of the firm tells us why there are firms, but it does not tell us why corporations are such a popular choice of organizational form for a firm.[70] It is suggested that the corporate form is a response to the problems of raising substantial amounts of capital for business enterprises. Separate legal existence, limited liability, liquidity, perpetual existence, and passive investment are the attributes of the corporation that have arisen in response to the problems of financing.[71]

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69. A.A. Berle & G.C. Means, *The Modern Corporation and Private Property*, rev. ed. (New York:Macmillan, 1968) at 313.

70. R.A. Posner, *The Economic Analysis of Law*, 4th ed. (Boston: Little Brown, 1993) at 392.

71. *Ibid.* at 394. Cf.: Cheffins, *supra* note 1 at 503 where Cheffins argues that in past business people have achieved limited liability without corporations. The methods by which this was achieved were, however, complex and expensive to implement. The corporation with its attribute of limited liability is, in and of itself, a transaction cost reducing institution. Its existence makes the extensive contracting aimed at avoiding liability unnecessary, thereby saving on the costs associated with that contracting.

Limited liability caps the risk to investors at the amount invested. This not only encourages investors to enter the market for the sake of risk taking and return generation on specific stocks, it also permits the use of portfolio diversification as a wealth development tool. Limited liability does not eliminate the risk: it only shifts it. The risk of loss shifts from the owners of the firm, the shareholders, to the firm's creditors. If shareholders were subject to unlimited liability, there would be a positive incentive for them to monitor not only the liabilities of the firm, but also the liabilities of all other shareholders in the firm. This would result, in most cases, in prohibitive costs. It is less expensive for the shareholders to compensate the firm's creditors for the creditors' increased risk by paying a higher rate of interest.[72]

"[The] owner of non-liquid property is, in a sense, married to it."[73] Liquidity[74] ensures that an investor can get out of the investment when it no longer suits her purposes. Liquidity has a positive effect on value, and it reduces the cost of raising capital.[75] Liquidity ensures

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72. Jensen & Meckling, *supra* note 67.

73. Berle & Means, *supra* note 69 at 249.

74. Liquidity denotes the ability to sell an asset without considerable price consquences or delay.

75. See: Y. Amihud & H. Mendelson, "Liquidity and stock returns" (1986) Financial Analysts Journal May-June 1986 43.

that the value of property can be realized through the establishment of a market price.[76]

The corporation's perpetual existence ensures that the death, retirement, or incapacitation of individuals will not affect its existence.

The corporate form allows shareholders to invest passively. Shareholders are not involved in the management of the firm. They need not incur the opportunity costs they would incur if active participation in the firm was required.[77]

Two conclusions can be drawn from these observations: first, the corporate form of organization is popular because it overcomes many of the obstacles to financing large business ventures, and, second, the corporate form seems to encourage investment by way of equity.[78]

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76. Berle & Means, *supra* note 69 at 250.

77. Posner, *supra* note 70 at 412.

78. Many of the points that make the corporation the organizational form of choice may not apply to closely held or mom-and-pop style corporations. In particular, the characteristics of limited liability and liquidity are not present in the mom-and-pop style corporations due to the realities of the financial markets they face. The focus of this thesis is publicly traded corporations. For that reason it is not necessary to adapt the arguments to include closely held and small corporations.

WHY EQUITY?

> How does it happen that millions of individuals are willing to turn over a significant fraction of their wealth to organizations run by managers who have little interest in their welfare? What is even more remarkable, why are they willing to make these commitments purely as residual claimants, i.e., on the anticipation that managers will operate the firm so that there will be earnings which accrue to the stockholders?[79]

People who have wealth want to put it to work in investments. People who have business ideas want that wealth so they can pursue those ideas. There are many ways for wealth holders to invest in firms. They can invest through fixed claims, bonds, notes, mortgages, etc.[80] Why, then, do they so often invest in the shares of corporations? The limited liability attribute of share holding is one suggested reason. Debt, however, is also has the attribute of limited liability. If limited liability were the only issue, given the tax subsidy on interest paid on debt, corporations where the owner-manager invests a very small amount and the balance is financed exclusively by debt would be expected to be the norm. This is not the case. Why? Three reasons are suggested:

> (1)the incentive effects associated with highly leveraged firms, (2) the monitoring costs these incentives engender, and (3) bankruptcy costs. Further more, all these costs are simply particu-

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79. Jensen & Meckling, *supra* note 67 at 330.

80. *Ibid.*

> lar aspects of the agency costs associated with the existence of debt claims on the firm.[81]

In essence, the incentive effects are the opportunities for self-interest seeking that an owner-manager of a heavily leveraged firm can pursue. Due to the resulting financial structure, the gains of the firm will go to the owner-manager while the risk of loss will be borne by the creditors. And the owner-manager will be predisposed to enter into high risk transactions. Debt holders will, then, insist on close monitoring which is not costless. That cost will be reflected in the cost of borrowing. In the absence of credible commitments on the part of the owner-manager, the cost of borrowing will become prohibitive. Just as monitoring is not costless, neither is bankruptcy. The costs of bankruptcy will be of concern to fixed claim holders because those costs will reduce the claim holders' recovery in the event of bankruptcy. The price that will be paid for fixed claims is inversely related to the possibility of bankruptcy and self-interest seeking behaviour on the part of owner-managers.[82] Debt financing will, therefore, become prohibitively expensive and firms will not use it to raise needed capital. They will, instead, use a combination of equity and debt financing.[83]

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81. *Ibid.* at 334.

82. *Ibid.* at 341.

83. See however: M.H. Miller "Debt and taxes" (1977) 32 no.2 Journal of Finance 261.

This result is seen in practice. Corporations use both debt and equity for financing. There are factors that encourage equity financing and discourage debt financing, but are there factors that encourage debt financing?

The most obvious factor that encourages debt financing is the tax subsidy on interest payments:[84] interest is paid with before-tax dollars; dividends are paid with after-tax dollars. Debt will also be used if the ability to pursue profitable opportunities is limited by the resources of the firm's owners.[85] In the end, the ratio of debt to equity will depend on a wide variety of factors. The costs associated with each form of financing will affect the choice of the means by which the firm raises the funds it needs. As for the investor, while risk aversion is generally an important element in investment decision making, so too is a desire for a substantial return. Equity capital is expensive capital. This implies high risk and high returns which contributes to the attractiveness of equity investments.

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84. P. Lusztig, R. Morck & B. Schwab, *Managerial Finance in a Canadian Setting*, 5th ed. (Toronto: John Wiley & Sons, 1994) at 489.

85. Jensen & Meckling, *supra* note 67 at 343.

CORPORATE GOVERNANCE

Separation of Ownership and Control

> A typical business is both a firm and a corporation. Control of the firm resides in the management group.[86]

The individual shareholder's interest is a financial one. It is not a proprietary or a managerial interest. It does not include the right to affect the day-to-day functioning of the corporation. A shareholder would incur opportunity costs if they had a proprietary or managerial interest in the firm. The separation of ownership and control can, then, be considered efficient and proper.[87] The issue of separation of ownership and control has, as a result, been called a "false issue."[88] This does not, however, preclude the existence of conflicts between the interests of the managers and the interests of the shareholders.

Liquidity depends on the separation of ownership from control, and liquidity is an important attribute for investors. Corporate law has removed much of the public corporation's shareholders' power, and this has caused those shareholders to rely on a public market for the realization of the value of their investment.[89] This public market

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86. Posner, *supra* note 70 at 409.

87. *Ibid.* at 411.

88. *Ibid.*

89. Berle & Means, *supra* note 69 at 247.

requires liquidity and alienability of shares to function. Without liquidity, the value of property is much harder and more costly to determine.[90] Without alienability, the shareholder cannot terminate the investment. The separation of ownership from control makes the shareholder's claim a purely financial one that can be easily alienated. "... [A] liquid token [the security] acquires value purely and simply because of its liquidity."[91] This is the essence and the source of a "new definition of private property" suggested by Berle and Means. They argued that the traditional doctrine of private property equated ownership with control. The law expected and protected active ownership. The new definition deals with and protects a passive ownership. It is within this new concept that the discordant interests of shareholders and managers will have to be resolved.

The divergence of the interests of the managers and shareholders begins with the sale of equity interests by the owner-manager (the separation of control and ownership) and this leads to agency costs.[92] Restraining the self-interest seeking behaviour of the managers is viewed as a problem of monitoring and controlling. Apportioning the costs that result is the function of the markets.[93]

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90. *Ibid.* at 250.

91. *Ibid.* at 251.

92. Jensen & Meckling, *supra* note 67 at 312.

93. *Ibid.* at 328.

Shareholders and the Corporation

Shareholders own the corporation. Historically, the concept of ownership included the right of active control over the use of the property and responsibility for its use. The shareholder was originally conceived as a quasi-partner.[94] Over time, the rights of the shareholder diminished until they have lost virtually all their power to affect the corporation:[95]

> [A shareholder has a] set of legal rights which can hardly be enforced, constituting claims on economic operations from which the individual shareholder is separated by so many barriers, present an appearance of satisfactory legal relationships to the enterprise, which in practice have little significance to the individual investor.[96]

A non-controlling shareholder has no direct influence over the use to be made of the corporation's assets, and shareholders have no responsibility for the use made of the corporation's assets.[97] What, then, is the relationship

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94. In Britain the company was traditionally viewed as a voluntary association of the shareholders. Prior to the enactment of the *Companies Act 1862* (25 & 26 Vict., c.89) "joint stock companies" were used to avoid the unlimited liability of partnerships, which until then was the only form of business organization, other than by special Act or Royal Prerogative, that allowed for joint pursuit of business ventures. Cheffins, *supra* note 1 at 39-40.

95. Jensen & Meckling, *supra* note 67 at 245, 247.

96. *Ibid.* at 252.

97. Any initiatives undertaken by non-controlling or atomistic shareholders face a free-rider problem. They can not expropriate a sufficient proportion of the benefit of the initiative for themselves. The controlling shareholders

(continued...)

between shareholders and the corporation and, specifically, how do shareholders ensure that the corporation is managed so as to maximize their wealth?

Controlling the Managers

How do the shareholders control the actions of management? What forces are brought to bear to keep the self-interest seeking of the managers to a minimum? These are important issues. A means must be found of discouraging management from expropriating an inappropriate amount of the corporation's assets to their own use. It is argued that bad management causes a corporation's share price to fall. With the drop in the market value of the firm, the risk of take-over or merger increases, and, with that, there arises a very real possibility that the managers will lose their jobs. It is in the managers' self-interest to do a good job of managing the firm.

The capital market, and the threat of a take-over, are presumed to have a powerful effect on management's behaviour. But take-overs are costly, and only those that promise a significant gain on the part of the acquiror will be

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97. (...continued)
will receive the bulk of the benefit. See for example: R.E. Hoskisson, & T.A. Turk, "Corporate restructuring: Governance and control limits of the internal capital market" (1990) 15 Academy of Management Review 459 at 464; and S.J. Grossman, & O.D. Hart, "Takeover bids, the free-rider problem, and the theory of corporation" (1980) 11 Bell Journal of Economics 691.

attempted.[98] It may, therefore, be in the best interests of shareholders to make specific provisions in the corporate constitution that encourage take-overs by making them less expensive. In this way the managers will be more at risk from the market for corporate control, and, presumably, they will manage the corporation more in accordance with the shareholders' best interests.[99]

Corporate law presumes that the firm will be managed in a manner consistent with the best interests of the shareholders', not the managers' best interest. This presumption also aids in the discipline of management.[100] It creates a simple decision rule that maximizes shareholder wealth through the maximization of share value. In markets characterized by competition, the maximization of share value leads to the efficient[101] allocation of resources, and it "... aligns organizational forms with incentives."[102]

Shareholders, generally, desire passive investments. They are not interested in expending large amounts of time

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98. B.R. Holmstrom & J. Tirole, "The theory of the firm", R. Schmalensee & R.D. Willig, eds., *Handbook of Industrial Organization*, Vol. 1, (New York: North Holland, 1989) 61.

99. *Ibid.* at 101.

100. R. Romano, *The Genius of American Corporate Law*, (Washington D.C.: AEI Press, 1993) at 2.

101. In this usage "efficiency" refers to allocative efficiency: the allocation of resources to their most highly valued use. Cheffins, *supra* note 1 at 6.

102. Romano, *supra* note 100.

and money monitoring the activities of the firm's managers. This is especially true for those investors with holdings in several firms. Internal monitoring is expensive, and it reduces the funds available for dividends or growth. As a result, those methods of control of managers calling for shareholder scrutiny and oversight are not practical.[103] There is, however, another form of scrutiny that can advance the interests of the shareholders. This is the scrutiny maintained by the market for corporate control.

The Market for Corporate Control

Like all markets in financial and economic theory, and practice, this market is a concept: it is not a place. It is located wherever someone who can set a corporate control transaction into motion is monitoring the performance of firms. Identifying poorly managed, undervalued or otherwise attractive firms and to react to the opportunities presented are the principal activities of this market.[104]

Financial markets are assumed to be efficient. That is, the current price of any stock reflects all of the publicly available information about the firm, and it reflects some of the private information. If a firm's management is

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103. An example of such a plan would be an annual audit of managerial activities, prepared by outside experts, delivered to shareholders, and debated at the annual general meeting.

104. The market for corporate control is the market where managment teams compete for the control of corporate assets.

conducting business in a manner that favours management's self-interest over the interests of the shareholders, the firm's share price will be lower than it would be if the firm were being run with an eye to maximizing shareholder wealth.[105] When such a situation is identified, the firm becomes an object for consideration within the market for corporate control. A number of different parties may become involved in a series of attempts to acquire control of the under-performing firm. Whatever the motivation for their interest, a depressed share price will attract attention. That attention, and the subsequent completion of a take-over, often leads to the dismissal of incumbent management.[106]

The market for corporate control disciplines managers through the threat of losing their jobs. The degree to which this discipline will affect their conduct is tempered, or amplified, by the likelihood that a take-over will actually occur. Financial market liquidity will have a direct impact on this likelihood.[107] In times of high liquidity and easy cash, the threat to under-performing managers is higher. The

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105. Posner, *supra* note 70 at 412.

106. Romano, *supra* note 100 at 52. This is an American observation, however the effect of a take-over on incumbent management in Canada appears, on anecdotal evidence, to be similar.

107. Jensen & Meckling, *supra* note 67 at 329. See also: W.H. Mikkelson, & M.M. Partch, "The decline of takeovers and disciplinary managerial takeover" (1997) 44 Journal of Financial Economics 205.

market for managers also has an effect.[108] First, the managers will be concerned about their own reputations in the market. Second, the general conditions of the supply of and the demand for managers will be relevant. In times of rapid economic expansion a manager may feel less constrained by the possibility of job loss than in times of economic down-turn.[109]

Factors Affecting the Market for Corporate Control

Corporations are legal fictions. Their personalities are primarily determined by the law under which they are established, and under which they function. Whether or not there is an efficient market for corporate control will, to a great extent, depend upon this legislative and regulatory environment. In the United States, the *Securities and Exchange Commission Rules*[110] that govern disclosure and anti-trust laws add to the costs of corporate control transactions.[111] Concern over corporate democracy have added to the cost of take-overs and have adversely affected the market

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108. *Ibid.* at 328.

109. See also: Cheffins, *supra* note 1 at 120-123 wherein Cheffins discusses limitations on the ability of the market for corporate control to discipline managers.

110. Enacted under the *Securities Act of 1933*, 15 U.S.C.

111. Posner, *supra* note 70 at 413.

for corporate control.[112] The purpose of anti-takeover legislation is to thwart otherwise rational takeovers,[113] and accordingly, this legislation has effects adverse to the ideal of market driven resource allocation. Empirical studies show a negative impact on the wealth of shareholders due to takeover legislation.[114]

In addition to direct legislative impact, the tolerance of the legal environment to take-over defences affects the functioning of the market for corporate control. "Poison pill" has become a term of art that refers to a variety of take-over defences. The common feature of these defences is that they make "swallowing" the target firm difficult. They are often referred to as "shareholders' rights plans." The terms of these plans are limited only by the imagination of management and their advisors. Poison pill defences have a negative impact on shareholder wealth.[115] In the United States, poison pill defences are a common alternative to anti-takeover legislation, and as the use of poison pills has increased, the importance of anti-takeover legislation

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112. *Ibid.*

113. Romano, *supra* note 100 at 11.

114. *Ibid.* at 60.

115. *Ibid.* at 70. See also: J.G. MacIntosh, "The poison pill: A noxious nostrum for Canadian shareholders" (1989) 15 *Canadian Business Law Journal* (1989) 276 at 281 *et. seq.* where MacIntosh evaluates the share price changes that accompany poison pill announcements.

has decreased.[116] The tolerance of a legal regime to poison pills, and other take-over defences, may have a greater impact on the efficiency of the market for corporate control than the specific legislative provisions regarding take-overs. This tolerance will have a negative impact on the interest shareholders have in maintaining the liquidity and alienability of their securities, and it will have a negative impact on the control that can be exercised over the self-interest seeking behaviour of managers.

THE ORTHODOX THEORY OF THE FIRM

Based on the foregoing discussion, a delineation of the orthodox theory of the firm can be proposed. The firm is an economic construct. Firms exist because it is more efficient to organize certain transactions within firms than it is to conduct those transactions in the market. The corporation is a type of firm with attributes that counter certain problems encountered in financing business enterprises. Equity is the prevalent form of corporate financing because of the higher agency costs associated with debt financing. Concerns over the control of management by the shareholders arise due to the transfer of equity to non-managers. This transfer separates ownership of the corporation from control of the corporation. Because of this separation, the role of corporate governance, including the market for corporate

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116. *Ibid.*, *Romano*, at 72. See also: *ibid.*, MacIntosh, at 277.

control and the take-over process, must be considered. These elements of the economic environment provide important checks on the behaviour of management.

Throughout the literature of transaction cost economics, the firm is presented as the shell that holds or facilitates economic activity.[117] The sole function of the firm is to facilitate the economic ambitions of the owners. It is an empty, lifeless shell animated only because the owners have empowered it with the right to conduct business on their behalf. Its form is dictated by the forces of the markets within which it functions, the contracts that characterize its relationships, and the legal environment within it was established and within which it exists. A firm is created, functions, and is terminated at the discretion of the economic actors that hold claims against it.

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117. Oliver Williamson has, however, introduced some question as to the dominance of this version of the firm. In "Comparative economic organization", *supra* note 7 at 270 he states that firms are not merely extensions of the market but rather they employ different means of governing transactions. And at 274:

> That it has been instructive to view the firm as a nexus of contracts is evident from the numerous insights that this literature has generated. But to regard the corporation only as a nexus of contract misses much of what is truly distinctive about this mode of governance.

INTERESTS THE FINANCIAL MODEL VALUES

The interests that the financial model of the firm values can now be determined. It can be seen that if the corporate form of the firm is to continue to flourish there must be a properly functioning capital market, and equity holders must be able to rely on the market for corporate control to discipline those who manage the corporations within which their wealth is invested. Accordingly, the financial model places a value on the interests of shareholders embodied in the characteristics of liquidity and alienability of their investments. Further, the shareholders' interests in the proper functioning of the market for corporate control through the proper flow of information and non-entrenchment of management are valued. It follows that, while recognizing several more constituencies with interests, the financial model requires that the interests of shareholders and the capital markets be advanced.

THE LEGAL MODEL OF THE CORPORATION

In drafting the legislation that governs the incorporation of companies within their jurisdictions, legislatures adopt, either knowingly or unknowingly, a legal model of the corporation. Canadian legislatures have, over

time, used two models:[118] the contractarian model, and the statutory division-of-powers model.[119] Corporations established under the different models are, for all intents and purposes, identical in terms of their external relationships, but their internal workings are different. These models reflect two contrasting approaches to the organization of the corporations.

Canadian corporate law was originally dominated by the older contractarian model which had been imported from England. Canadian corporate regimes underwent significant reforms in the 1970s when that model was, by and large, discarded in favour of the statutory division-of-powers acts which were based on American legislation.[120] A statutory division-of-powers act imposes a division of powers on the directors, shareholders, officers, and, to an extent, the

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118. B.L. Welling, *Corporate Law in Canada: The Governing Principles*, 2d ed. (Toronto: Carswell, 1991) at 37.

119. *Ibid.* at 54.

120. *Ibid.* at 38. The statutory division-of-powers model reflects an adaptation of the American approach to corporations. This model is used by Canadian statutes patterned on the *Canadian Business Corporations Act*, R.S.C. 1985, c. C-44 ("*CBCA*"). Included in those statutes are the Alberta *Business Corporations Act*, S.A. 1981, c. B-15 ("*ABCA*"); and the Ontario *Business Corporations Act*, S.O. 1982, c. 4 ("*OBCA*"). Some notes in this thesis will relate to the British Columbia *Company Act*, R.S.B.C. 1979, c.59 ("*BCCA*"). It is not, strictly speaking, a statutory division-of-powers statute. The *BCCA* is a hybrid of the two models. This statute has retained a contractarian model but has incorporated some of the *CBCA* style remedies. The *BCCA* is considered due to the increasing importance of Vancouver as a financial and business centre.

creditors of the firm.[121] The underlying concepts are status and remedy. The corporation's constitution is not a contract between the parties. Each category of participant has a status that is designated by the statute.[122] If participants require a remedy for a breach of the statute or the corporation's constitution, they have two sources of recourse: they can attempt a political solution; or they can invoke one of the remedies contained in the statute.[123]

Statutes based on the contractarian model establish memorandum and articles of association corporations.[124] The statutes contain a declaration that the corporate constitution is a contract between the corporation and shareholders, and they leave the division of powers between the participants to be determined by, and set out, in the corporate constitution.[125] This model concentrates on the concepts of contract and rights. All original authority in the corporation is held by the shareholders. The shareholders then delegate the duties and rights that are stipulated in the constitution. Directors and officers are not parties to

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121. *Ibid.*, Welling, at 54. See also: *CBCA*, ss. 102, 121, and 140; *ABCA*, ss. 97, 116 and 134; *OBCA*, ss. 115, 133 and 102; *BCCA* 132, 141, 157, 158, 33 and 185.

122. *Ibid.*, Welling.

123. *Ibid.* at 55. See also: *CBCA*, Part XX; *ABCA*, Part 19.

124. *Ibid.*, Welling.

125. *Ibid.*

the contract.[126] When shareholders are adversely affected by an action of a director or an officer they must either gain majority support for their position or find some personal right of their own, as created by the statute or constitution, that has been breached.[127] Accordingly, much of the litigation regarding this model is concerned with the standing of parties to bring actions. Only two jurisdictions in Canada, British Columbia and Nova Scotia, continue to use forms of this model.[128]

Appreciating the differences in the models both historically and jurisdictionally is vital to an understanding of the law and its applicability to a given situation.[129] Much of our older corporate jurisprudence is from England, and, as such, it is based on the contractarian model. These precedents may not be applicable in the modern Canadian context. Over time the role of English decisions has diminished and the importance of American precedents has increased due to the adoption of the new model.[130]

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126. *Ibid.*

127. *Ibid.*

128. *Ibid.*

129. *Ibid.* at 54.

130. *Ibid.* at 73.

CHAPTER SUMMARY

In Chapter 2 the financial theory of the firm was examined. From that theory a prescriptive model of the firm was developed and, in turn, the interests valued by that model were determined. The chapter ended with a discussion of the legal model of the firm. There is a primary, substantive difference between the financial and legal models. The legal model attributes an independent existence to the corporation; the financial model does not.

The explication of these models and interests is an important step in the analysis which lies at the heart of the thesis. Now that the financial model has been delineated attention can be turned to the second component of the analysis, that is, the legal regime that governs the take-over process. When the makeup of the legal regime has been fully developed the thesis will turn to a comparison of the two parts of the construct under consideration.

CHAPTER 3

STATUTORY CONTROL OF THE TAKE-OVER PROCESS

INTRODUCTION

In Chapter 2 a prescriptive model of the firm was developed, and the legal model of the corporation was introduced. That financial model will be the standard against which the legal regime is compared to determine whether or not the legal regime is consistent with the financial model. The operative question: does the legal regime advance the interests that the financial model values? To further this analysis, the current chapter provides a review of the substantive law that affects the conduct of a target firm's board of directors following receipt of an uninvited take-over bid. Specifically, it looks at the responses that the directors are required to make. Chapter 4 will review the effect of the *Canada Business Corporations Act*[1], ("*CBCA*"), on the directors of a target firm. In turn, Chapter 5 will review the law that sets out the responses of the target firm's board of directors that are optional and those responses that are prohibited.

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1. *Canada Business Corporations Act*, R.S.C., 1985, c. C-44, as amended.

The review of the law begins with a consideration of the statutory provisions that control the take-over process in Alberta. Much of what follows is descriptive, but it is necessary to facilitate the analysis that is being undertaken.

STATUTORY CONTROL IN ALBERTA

The Alberta *Business Corporations Act*

The *Alberta Business Corporations Act*,[2] ("*ABCA*"), imposes duties on the directors of corporations that are governed by the Act.[3] Amongst those duties is an obligation to "... manage the affairs and business of the corporation."[4] When the directors are performing this duty, they must adhere to the following standard of conduct:

> ... [To] act honestly and in good faith with a view to the best interests of the corporation, and [to]
>
> (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.[5]

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2. *Alberta Business Corporations Act*, R.S.A., 1980, c. B-15, as amended.

3. The *ABCA* governs those privately and publicly held corporations incorporated under the Act, continued under the Act, and, to an extent, those that are extra-provincially registered under the Act. See: *ABCA*, ss.1(f.1), 263-273.

4. *ABCA*, s.97(1).

5. *ABCA*, s.117.

This duty affects the way a target firm's board of directors responds to an uninvited take-over bid. What is the effect?

The board of directors is in charge of the business and affairs[6] of the corporation. The directors act pursuant to this duty through by-laws. These by-laws are effective unless and until they are rejected, amended, or repealed at the next shareholders' meeting.[7] The directors must perform this duty in accordance with the standard indicated above. The effect of these combined provisions is to impose a positive duty on the board of directors to consider the uninvited take-over bid and its effect on the corporation.[8]

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6. *ABCA*, s.1(a):
"affairs" means the relationships among a corpo-ration, its affiliates and the shareholders, directors and officers of those bodies corporate but does not include the business carried on by those bodies corporate.

7. *ABCA*, s.98(3).

8. See: *Sparling et al. v. Royal Trustco Ltd. et al.* (1984),45 O.R. (2d) 484 (Ont.C.A.) at 493.
Cory J.A writing for the Court:
In my view, a take-over bid comes within the concept of "affairs" of the corporation referred to in [the *Canada Business Corporation Act*]. Such a bid is concerned with the control of the corpo-ration which must be considered a vital affair of that corporation.
The *CBCA*, s.1 defines "affairs":
"affairs" means the relationships among a corpo-ration, its affiliates and the shareholders, directors and officers of such bodies corporate but does not include the business carried on by such bodies.

(continued...)

What the board must do to discharge this obligation will depend on the nature of the duty that is imposed on them. The nature of that duty will, in turn, depend on the nature of the relationship that exists between the board of directors and the corporation. Many judicial authorities have declared the relationship between the board of directors, or directors individually, and the corporation to be a fiduciary relationship.[9] It must be noted, however, that much of this case authority relates to English-model corporations. As a result, when considering corporations established under *CBCA* model statutes, this issue should be considered in light of the basic principles of fiduciary relationships rather than by reference to specific cases. See for example *Aberdeen Railway*.[10]

Can it be stated with assurance that the relationship between the directors of a corporation and that corporation, where that relationship is governed by the provisions of modern corporate statutes, is a fiduciary relationship?

The Supreme Court of Canada considered fiduciary relationships and duties in *International Corona Resources Ltd.*

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8. (...continued)
Accordingly, the decision of the Court in *Sparling* is supportive of the position argued for in the thesis. Due to its source, the Ontario Court of Appeal, it must be considered highly persuasive in Alberta.

9. See for example: *Calmont Leasing Ltd.* v. *Kredl et al.* (1993), 142 A.R. 81 (Alta. Q.B.) at para 97.

10. *Aberdeen Railway Co.* v. *Blaikie Bros.* (1854), 149 R.R. 32 (Scot.,H.L.) at 39.

v. *LAC Minerals Ltd.*.[11] LaForest J. quoted with approval an excerpt from "The Fiduciary Obligation", by Professor Ernest Weinrib, 25 U.T.L.J. (1975), at p. 7:

> ... [W]here by statute, agreement, or perhaps by unilateral undertaking, one party has an obligation to act for the benefit of another, and that obligation carries with it a discretionary power, the party thus empowered becomes a fiduciary. Equity will then supervise the relationship by holding him to the fiduciary's strict standard of conduct.

Justice LaForest dissented on the final question of liability, but he agreed with the majority on the characteristics of a fiduciary relationship. There are three:

(1) The fiduciary has scope for the exercise of some discretion or power.
(2) The fiduciary can unilaterally exercise that power or discretion so as to affect the beneficiary's legal or practical interests.
(3) The beneficiary is peculiarly vulnerable to or at the mercy of the fiduciary holding the discretion or power.[12]

Sopinka J., in the majority decision, repeated and affirmed that these characteristics define fiduciary relationships.[13]

An examination of the relationship between a corporation and its directors, conducted in the light of these characteristics, reveals that the relationship is fiduciary. The directors have significant scope for the exercise of

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11. *International Corona Resources Ltd.* v. *LAC Minerals Ltd.* (1989), 61 D.L.R. (4th) 14 (S.C.C.) at 27.

12. *Ibid.*

13. *Ibid.* at 63.

discretion and power. For example, the *ABCA* gives the directors the right and power to manage the business and affairs of the corporation.[14] The directors can, at their discretion, exercise considerable power and thereby affect the legal and practical interests of the corporation. And the corporation is vulnerable to its directors' use of their power. Indeed, LaForest J. specifically included the relationship between corporate directors and the corporation in a list of examples of a fiduciary relationship.[15]

It can, therefore, be concluded that the relationship between the directors and the corporation is a fiduciary one. Because the relationship is fiduciary, it can also be concluded that the duties imposed on the directors by s.97 are fiduciary duties. Wilson J. commented on this point in *International Corona*:

> It is, in other words, my view of the law that there are certain relationships which are almost *per se* fiduciary ... and that where such relationships subsist they give rise to fiduciary duties.[16]

The quotation from Professor Weinrib included by the majority in the *International Corona* decision, and referenced above, dealt with the connection between fiduciary relationships and fiduciary duties:

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14. *ABCA*, s.97(1).

15. *International Corona*, *supra* note 11 at 28.

16. *Ibid.* at 16.

> It is the nature of the relationship, not the specific category of actor involved that gives rise to the fiduciary duty.[17]

Considering the provisions of the *ABCA*, s.117, the characteristics discussed above, and the specific inclusion of directors as an example of a trustee, there should be little doubt that the relationship between a director and the corporation is a fiduciary one. And there should be little doubt that the duties imposed under *ABCA*, s.97 are fiduciary duties.

This conclusion should be compared to comments made by Professor Welling on this issue.[18] Welling observed that the duty imposed on directors in the context of modern corporate law is not, strictly speaking, the same as the fiduciary duties found in Equity. He agreed, though, that the likely outcome of a breach of the statutory duty will be the same liability as that arising under a fiduciary duty imposed by Equity. He concluded his discussion by saying:

> In sum, it makes little sense to quibble on this point and I shall proceed on the assumption that the reformed Canadian statutes have not changed the equitable imposition of the accountability principle.[19]

This outcome should have a strong influence on the conduct of the board of directors of a target firm. In

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17. *Ibid.* at 27.

18. B.L. Welling, *Corporate law in Canada the Governing Principles*, 2d ed. (Toronto: Carswell, 1991) at 386-387.

19. *Ibid.*

particular, it should have a significant effect wherever there is a potential for a conflict of interest. The board of directors of a distributing corporation[20] in Alberta must consist of no fewer than three directors, and at least two must be persons who are not officers or employees of the corporation,[21] that is, independent directors. Due to the fiduciary nature of the relationship between the directors and the corporation, the board of directors must be awake to the possibility of a conflict between the best interests of the corporation and their own interests. The potential for conflict is greatest for the inside directors.[22] In the context of a take-over, these directors must recognize this potential and avoid it.[23]

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20. *ABCA*, s.1(i):
"distributing corporation" means a corporation
(i) any of whose issued shares, or securities which may or might be exchange for or converted into shares, were part of a distribution to the public, and
(ii) which has more than 15 shareholders.
In this chapter it is assumed that the corporation in question is a distributing corporation.

21. *ABCA*, s.97(2).

22. Those who are, in addition to being directors, are also employees or officers of the corporation.

23. *Aberdeen Railway Co.*, *supra*. note 10, 23 at 39, per Lord Cranworth L.C.:
The directors are a body to whom is delegated the duty of managing the general affairs of the Company.
A corporate body can only act by agents, and it is of course the duty of those agents so to act as best to promote the interests of the corpo-ration whose affairs they are con-
(continued...)

One means of avoiding the conflict is to use an independent committee of the board of directors. The independent committee is made up of members of the board of directors who are not inside directors. It is established with a mandate, delegated from the board of directors,[24] to consider the acceptability of the take-over bid.[25] It will function independently of the board of directors in matters relating to acceptability of the take-over bid, and it will consider whether or not to recommend acceptance of the bid. There appears to be no specific statutory or regulatory requirement in Alberta for the establishment of such a committee in the circumstances of a take-over bid although, based on anecdotal evidence, the practice seems to be followed.[26]

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23. (...continued)
ducting. Such agents have duties to discharge of a fiduciary nature towards their principal. *And it is a rule of universal application, that no one, having such duties to discharge, shall be allowed to enter into engagements in which he has, or can have, a personal interest conflicting, or which possibly may conflict, with the interests of those whom he is bound to protect.* [emphasis added]

Where a fiduciary relationship exists, the law protects the beneficiary from a conflict of interest.

See also: *ABCA* s.115(5) which prohibits a director from voting on resolutions that relate to contracts in which the director has a material interest.

24. *Ibid.*, *Aberdeen Railway*. See also: *ABCA*, s.110(1).

25. J.A. Millard, *The Responsible Director*, (Calgary: Carswell, 1989) at 46-48, 81. See also: *Brant Investments Ltd. et al.* v. *Keeprite Inc. et al.* (1987), 37 B.L.R. 65 (Ont. S.C.) at 92 *et seq.*

26. *Ibid.*, Millard.

This procedure is consistent with the duties imposed on the directors by the *ABCA* and the common law. In the absence of prohibitive cost or other intractable difficulty, the practice should be followed in all cases involving a take-over bid.

Take-Over Bids Under The Alberta *Business Corporations Act*

Part 16 of the *ABCA* deals with take-over bids as defined in that Act in s.187(g):

> "take-over bid" means an offer made by an offeror to shareholders to acquire *all of the shares of any class of share of an offeree corporation* not already owned by the offeror, and includes every take-over bid by a corporation to repurchase all of the shares of any class of its shares which leaves outstanding voting shares of the corporation. [emphasis added]

The take-over bid provisions of the *ABCA* cover only those take-overs that will result in the acquiring corporation obtaining 100% of the relevant class of shares. This Part of the *ABCA* is used in situations involving non-distributing corporations (as contemplated by the *ABCA* and the *Alberta Securities Act*[27]), or in the final steps of going

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27. *ABCA* s. 1(i):
"distributing corporation" means a corpo-ration
(i) any of whose issued shares, or securities which may or might be exchanged for or converted into shares, were part of a distribution to the public, and

(ii) which has more than 15 shareholders;

(continued...)

private transactions (as defined by the *Alberta Securities Commission Rules*[28]) where the going private transaction occurs subsequent to the use of one of the take-over processes provided for in the *ASA*.

Summary of the Effect of the Alberta *Business Corporations Act*

The *ABCA* imposes a positive duty on directors, both individually and as a board, to act in the best interests of the corporation when a take-over bid is presented. Inside directors should not participate in deliberations on the acceptability of the take-over bid due to a possible con-

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27. (...continued)
The Alberta *Securities Act*, S.A., 1981, c.S-6.1, as amended, ("*ASA*") s.1(p.1):

> "private company" means a company in whose constating documents
> (i) the right to transfer its shares is restricted,
> (ii) the number of its shareholders, exclusive of
> (A) persons who are in its employment ... and
> (B) persons who, having been formerly in its employment ... were, while in that employment, shareholders of the company and have continued to be shareholders of that company after termination of that employment,
> is limited to not more than 50 persons ....
> (iii) any invitation to the public to subscribe for its securities is prohibited.

The definition in the *ASA* is more restrictive. However, the essential elements of a non-distributing company are clear. It is a corporation whose shares are not available to the public and has a limited number of shareholders.

28. *Alberta Securities Commission Rules*, Alta. Reg. 46/87 ("*ASCR*"), s.170(a).

flict of interest. An independent committee of the board of directors should be established to consider the bid. *ABCA*, Part 16 deals with take-overs, but its application is limited in scope and is not germane to this thesis.

THE SECURITIES STATUTES

The take-over process is governed by the relevant securities acts, regulations, rules, blanket orders, national and local policies, notices, and the discretionary authority of the securities commissions. Under this regime, the take-over process is a closed system. That is, all take-overs will be governed by the statutory system unless that system grants them an exemption.[29] The statutes provide for take-overs to be prosecuted by way of bids made pursuant to those statutes, or, in the case of a target corporation that is incorporated under the *CBCA*, pursuant to the provisions of that statute.[30] Such take-over bids are known as "circular bids."[31]

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29. See: *Alberta Stock Exchange Circular Number 10*. This circular discusses the take-over bid process as a closed system, that is, the take-over is regulated unless there is an exemption.

30. *CBCA*, ss. 98-102.

31. See for example: *ASA*, ss.131-145.

Take-over bids under the Alberta *Securities Act*

The Alberta *Securities Act* ("*ASA*"), ss.131-145 (Part 13), and Part 13 of the *Alberta Securities Commission Rules* ("*ASCR*"), regulations made under s.74 of the *ASA* cover the conduct of take-over bids made to offeree security holders in Alberta. A take-over bid is defined in *ASA*, s.131(1)(r):

> "take-over bid" means an offer to acquire outstanding
> (i) voting securities of a class of the offeree issuer, or
> (ii) equity securities of a class of the offeree issuer,
> that is made to any person or company that is in Alberta or to any holder in Alberta where, as of the date of the offer to acquire, securities that are subject to the offer to acquire, together with the offeror's securities, constitute in the aggregate 20% or more of all outstanding securities of that class of securities.

Any transaction that satisfies this definition is *prima facie* governed by the rules in Part 13 of the *ASA* and is referred to as a circular bid. Part 13 provides certain exemptions from the application of these rules. There is, amongst others, an exemption for take-over bids made through the facilities of a recognized stock exchange.[32]

Circular bids in Alberta[33]

There are numerous statutory provisions that affect the circular bid process. They are found in a number of statutes, regulations, rules and policies. The relevant provi-

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32. *ASA*, s.132(1)(a).

33. In this portion of the thesis it is assumed that the target corporation is an *ABCA* corporation.

sions will be reviewed as they arise in the description that follows.

Commencement of a Circular Bid

When a firm has decided to launch a take-over (the "offeror") of another firm (the "offeree") using the procedures contained within Part 13 of the *ASA*, they will start the process with the preparation and distribution of a bid and "bid circular." All aspects of the take-over bid and the circular are governed by the *ASA*, the *ASCR*, the *ASA Regulations*, local and national policies, blanket orders, and notices.

ASA s.135 provides, among other things, that the bid shall be made to all those persons and companies in Alberta that hold the securities sought.[34] A minimum of 21 days must be allowed from the date of the bid during which the securities may be deposited.[35] This section governs when the securities may be taken up by the offeror,[36] when the security holders can withdraw the securities,[37] how the securities will be taken up if there is an over-subscription to

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34. *ASA*, s.135(a).

35. *ASA*, s.135(c).

36. *ASA*, s.135(d).

37. *ASA*, s.135(e).

the bid,[38] and when the acquiror must pay for the securities that are taken up.[39]

ASA, s.136(1) requires that all holders of the affected class of securities are to be offered identical consideration. *ASA*, s.136(2) prohibits the offeror from making any deals with security holders outside the take-over process that would result in that security holder receiving consideration of a greater value than that which will be received by the others under the terms of the take-over bid. *ASA*, s.135(3) provides that if the consideration for the bid is increased after some securities have been taken up, those whose securities have been taken up are to receive the increased consideration.

ASA s.137(1) requires that a bid circular be sent to all security holders along with the take-over bid. *ASA*, s.137.1 calls for the offeror to give notice of any changes or variations to the terms of the bid (a "notice of variation").

Section 137.2:

> A take-over bid circular, an issuer bid circular, a notice of change and a notice of variation shall be in the form and contain the information prescribed by the Part and the regulations.

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38. *ASA*, s.135(i).

39. *ASA*, ss.135(k)&(l).

The *ASCR* stipulates that the take-over bid circular must comply with Form 31,[40] and the contents of a notice of change to the take-over bid is governed by *ASCR* s.181.1.[41] The contents of the take-over bid circular are not, for the most part, vital to an understanding of the duties of the target firm's board of directors. As such, those contents will be dealt with only when they are pertinent to the discussion of the directors' duties.

Response to the Circular Bid

ASA, s.138(1) requires the board of directors of the offeree corporation to prepare and send a directors' circular to all those who received the take-over bid circular. The directors' circular is to be sent out no later than 10 days after the date of the take-over bid.[42] The circular must recommend either acceptance or rejection of the take-over bid,[43] or the board may expressly decline to make a recommendation.[44] The directors must give reasons for their

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40. *ASCR*, s.177.

41. *ASCR*, s.181.1 requires a description of the change in information or variation in the terms of the offer, the date of the change or variation, the date up to which securities may be deposited, the date the offeror must take up the securities that are tendered, the security holders' rights of withdrawal, and a certificate in the form required by Form 31 which is signed by an appropriate individual.

42. *ASA*, s.138(1).

43. *ASA*, s.138(2)(a).

44. *ASA*, s.138(2)(b).

recommendation or lack of recommendation.[45] The board, if they intend to make a recommendation but are not yet in a position to do so, must indicate this intention in the directors' circular.[46] And the directors may advise the security holders not to tender until they make the recommendation.[47] If the board takes the course of delaying a recommendation, any recommendation they do make must be sent out not less than seven days before the expiration of the take-over bid.[48] If there are any changes to the information contained in the directors' circular that would reasonably be expected to affect the decisions of security holders the board of directors must send out a notice of change disclosing the nature and substance of the change.[49]

ASA, s. 139 allows an individual director or officer to recommend acceptance or rejection of the take-over bid by sending a separate circular that complies with the regulations.[50] The expense of sending this circular is to be borne by the offeree corporation.[51]

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45. *ASA*, ss.138(2)(a)&(b).
46. *ASA*, s.138(3)(a).
47. *ASA*, s.138(3)(b).
48. *ASA*, s.138(4).
49. *ASA*, s.138(5).
50. *ASA*, s.139(1).
51. *ASA*, s.139(3).

The form and content of the directors' circular and the circular of any individual directors or officers must comply with the *ASA* and the *ASCR*.[52] *ASCR*, s.178 requires that the directors' circular comply with Form 32, and *ASCR* s.181.2 governs the contents of a notice of change to a directors' circular.[53]

The dominant purpose of the take-over bid circular and the directors' circular is to provide information to the security holders.[54] It is expected that this information will be used by the security holders to make informed decisions as to whether or not to tender to the take-over bid. The information contained in the circular must be complete and accurate. It is the responsibility of the directors to prepare the circular, but the offeree corporation is also at risk if the information supplied does not satisfy the requirements of the statutes and rules.[55] Consideration must, therefore, be given to the burden placed on the directors to ensure the accuracy and completeness of this information.

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52. *ASA*, s.139.1.

53. *ASCR*, s.181.2 requires that the notice of change contain a description of the change and that it contain a cer-tificate that complies with the certificate required by Form 32 that is signed by an appropriate individual.

54. The underlying assumption here appears to be a concern that the market is not efficient enough to generate this information itself. The law is giving the market a hand-up by forcing this disclosure.

55. *Sparling*, *supra* note 8 at 493.

Burden on the Directors to Ensure Accuracy

The burden that is imposed on the directors to ensure accuracy and completeness in a circular is not explicitly spelt out by the statutes or rules. It must be determined by considering the regulatory framework as a whole. As in many aspects of securities regulation, it may be appropriate to look to American sources for guidance on this point.

Comparability of Disclosure Standards in American and Canadian Statutes

It is a basic principle of securities regulation that all investors should have equal access to information that may affect their investment decisions.[56] This policy is apparent in both the American and Canadian schemes of securities regulation.[57] Disclosure is the means by which the regimes facilitate the release of information. Disclosure is itself tied to the concept of materiality, and it is supported by sanctions for failure to satisfy the relevant standards.[58] The American and Canadian regimes use notably similar provisions to protect the quality of disclosure which they require. To ensure the quality of disclosure,

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56. See for example: *National Policy No. 40 Timely Disclosure*, Paragraph B.

57. See for example: M.R. Gillen, *Securities Regulation in Canada* (Scarborough, Ont.: Carswell, 1992) at 144-146; and *Feit* v. *Leasco Data Processing Equipment*, 332 F.Supp. 544 (U.S.D.C., E.D.N.Y. 1971) at 563-566.

58. *Ibid. Feit*, at 564. See also: *Sparling*, *supra* note 8 at 490.

these regimes impose liability for errors in documents on those persons (both natural and juridical) who are responsible for the preparation of the documents. The regimes then grant relief to those persons if a standard of reasonableness in the preparation of the documents has been met. The similarities between the regimes in this regard is quite conspicuous. For example, the basis for liability regarding errors in non-expert sections of a prospectus or similar document is the same under the American statute as it is under the *ASA*.[59] The similarities continue in the provisions regarding errors within the expert portions of the docu-

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59. See: *ASA*, s.169(2) and *Securities Act of 1933*, 15 U.S.C. ("*SEC*"), s.77k:

> (a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, ... sue ....
> (b) Notwithstanding the provisions of subsection (a) of this section no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof ... (3) that (A) as regards as part of the registration statement not purporting to be made on the authority of an expert, ... he had, after reasonable investigation, reasonable ground to believe and did believe, ... that the statements therein were true and that there was no omission to state a material fact ....

ments,[60] and in the provisions that deal with the liability of the experts themselves.[61]

The statutory regimes do exhibit some apparent dissimilarities. These differences are, however, in the nature of form and not substance. The *ASA* s.1(1) defines "material fact" as a fact that significantly affects or would reasonably be expected to have a significant effect on the market price or value of the securities. The American regime defines "material" in the Regulations of the Securities and Exchange Commission:

> The term 'material', when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered.[62]

The American statute combines the concept of materiality with fact in the provisions that govern liability.[63] And although the test given for materiality in the

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60. *Ibid. SEC*, s.77k(b)(3)(C). In both statutes, where the portion of the document is an expert portion, those who are responsible for the contents of the document, other than the expert himself, must make a reasonable investigation and be satisfied that there is no reasonable ground to believe and he did not believe, that the statements were untrue or that there were no omissions. See also: *ASA*, ss.168(4)(c), 169(5)(c).

61. See: *ASA* ss.168(5), 169(6); *ibid. SEC*, s.77k(b)(3)(B). The expert must have made a reasonable investigation and had reasonable grounds to believe that the statements in the document were true and that there were no omissions.

62. 17 C.F.R. s.230.405(1).

63. See for example: *SEC*, *supra*. note 59.

American regime is different from that used in Alberta, the outcome of the test is the same. A significant effect on the value or price of a security is something that an average prudent investor should know before purchasing the security.[64] As a result, the concept of materiality within the American and Alberta regulatory schemes can be considered sufficiently similar for purposes of this thesis.[65]

Another apparent, though not substantive, difference is found in the concept of "reasonable investigation." The *Securities Act of 1933* defines "reasonable investigation":

> ... [W]hat constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.[66]

The *ASA* does not define "reasonable investigation", nor does it define "reasonable inquiry." However, as discussed,

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64. It could be suggested that the American regime uses a wider concept of materiality than the Alberta regime. That is, there may be material facts (as defined by the American statutes) that do not affect the price of the securities. While this argument has appeal, it must be remembered that in the context of the capital markets all relevant information is reflected in the price of the security. As a result, if a fact is material under either statute it will be material under the other.

65. See: *Sparling*, *supra* note 8 at 490 where the Ontario Court of Appeal looks at the definition of materiality in *TSC Industries, Inc. et al.* v. *Northway, Inc.* 426 U.S. 438 (U.S.C.A. 7th Cir. 1976) which was mentioned with approval in *Royal Trustco Ltd. et al.* v. *Campeau Corp. et al.* (1980) 31 O.R.(2d) 75 (Ont. C.H.J.) at 101, and was consequently applied in *Sparling*.

66. 15 U.S.C. s.77k(c).

the *ABCA* places a positive duty on the directors to "... exercise the care, diligence and skill that a reasonably prudent person would exercise in similar circumstances."[67] The duty to make a reasonable inquiry contained in the *ASA* and the standard in the *ABCA* join and impose the same burden on directors in Alberta as the American statute imposes on those under its jurisdiction. Others involved in the preparation of the documents in Alberta may not be governed by this standard. This thesis focuses on the duties of directors, and for the purposes of the discussion to follow, the standards in the United States and Alberta will be treated as the same.

A further argument in favour of looking to the American jurisprudence for guidance is found in the similarity of the policies underlying American and Canadian regimes. Both state explicitly that a paramount policy consideration is the protection of the investing public.[68] Both adopt disclosure as the means by which the policy objective is to be achieved.[69] Both restrict disclosure requirements to material facts. Both grant exculpation from liability on the basis of reasonable investigation. And in both jurisdictions policy considerations are explicitly mentioned by the courts

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67. *ABCA*, s.117(1)(b).

68. See for example: *Feit*, *supra*. note 57 at 549; Gillen, *supra* note 57.

69. See for example: *ibid. Feit*, at 564.

when they are considering the application of securities regulation.[70]

In sum, though the American authorities are not binding on Canadian courts, it is appropriate to look to them when exploring issues of disclosure. This conclusion is consistent with the practice of Canadian courts.

Standards Imposed for Prospectus and Circular Preparation

The securities regimes impose standards of quality on the disclosure contained in prospectuses. Can directors involved in preparing a circular gain guidance on issues of disclosure by looking at the provisions that relate to disclosure in prospectuses?

The regulatory system provides incentives for the provision of "full, true and plain" disclosure in a prospectus[71] through the use of devices such as statutory civil sanctions for misrepresentations.[72] In addition, there are penal sanctions for misrepresentation in documents that must be filed.[73] The provisions that govern the quality of disclosure required in circulars do not repeat the "full, true

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70. See for example: *Sparling*, *supra* note 8 at 493; *Lake and Co.* v. *Calex Resources Ltd.* (1995) 7 C.C.L.S. 308 (Alta. Q.B.) at para 47.

71. *ASA*, s.84(1).

72. *Gillen*, *supra* note 57 at 121. See also: *ASA*, s. 168.

73. *ASA*, s. 161.

and plain" standard. Nonetheless, an examination of the provisions that govern circulars reveals that the provisions that provide for sanctions for misrepresentation in circulars mirror the provisions that impose sanctions for misrepresentations in prospectuses. There are provisions imposing statutory civil liability for misrepresentations in circulars,[74] and there are provisions for penal sanctions for misrepresentation in circulars.[75] Consequently, to avoid liability, those who prepare circulars must adhere to the same standards as those who prepare prospectuses. These standards are also applicable to notices of change or variation to the circulars.[76] The discussion to follow will refer only to circulars and not to the notices of change or variation. All comments regarding the quality of disclosure required for circulars are equally applicable to the disclosure required for notices of change and variation.

The Quality of Disclosure

What standard of quality of disclosure must the board of directors adhere to when preparing the directors' circular? If they wish to avoid civil and criminal liability they

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74. *ASA*, s. 169.

75. *ASA*, s. 161(1)(b) makes it an offence to make a misrepresentation in any document that is required to be filed. *ASA* s.140(3) requires the directors' circular to be filed. Therefore, if there is a misrepresentation in the filed directors' circular there is a *prima facie* offence.

76. See for example: *ASA*, s.169(1).

must guard against a breach of the statutes, regulations, and rules that apply to the process. And the principle concern in this regard will be avoiding misrepresentations.

ASA s.1(m):

> "misrepresentation" means
> (i) an untrue statement of a material fact, or
> (ii) an omission to state a material fact that is required to be stated, or
> (iii) an omission to state a material fact that is necessary to be stated in order for a statement not to be misleading.

Material fact is defined in the *ASA* s.1(l):

> "material fact" when used in relation to securities issued or proposed to be issued means a fact that significantly affects or would reasonably be expected to have a significant effect on the market price or value of the securities.

The directors' circular must be filed with the Executive Director of the Securities Commission.[77] This requirement creates a potential for penal sanctions against the directors under *ASA* s.161 in the event there is a misrepresentation in the circular. These provisions create strong incentives to ensure that the directors' circular does not contain untrue statements of fact that significantly affect, or would reasonably be expected to have a significant effect, on the market price or value of the securities which are the subject of the take-over bid.

Directors are not, however, guarantors of the veracity of the information contained in the directors' circular. It does appear, at first, that the directors face a very high

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77. *ASA*, s.140(3).

standard. A standard that requires them to ensure there are no misrepresentations in the directors' circular. However, s.161(3) provides relief:

> No person or company is guilty of an offence under subsection (1)(a) or (b) if [they]... did not know, and on the *exercise of reasonable diligence* could not have known, that a misrepresentation was made. [emphasis added]

In addition, *ASA*, s.169(c) grants relief from the liability imposed by ss.169(1)&(2) in regard to portions of the circular purporting to be made on the authority of an expert or purporting to be a copy of or an extract from an expert report. There will be no liability if "he ... *had no reasonable grounds* to believe and did not believe (i) that there was a misrepresentation ...." [emphasis added] *ASA*, s.169(7), if satisfied, provides a defence to liability for misrepresentations in portions of the circular not based on expert opinion or reports. However, the defendant will not be protected by this section if he "... did not conduct an investigation sufficient to provide *reasonable grounds for a belief* that there had been no misrepresentation, or ... believed there was a misrepresentation." [emphasis added] Consequently there are statutory defences available to protect directors and others from both penal and civil liability for misrepresentations in circulars.

A misrepresentation, as defined in the *ASA*, is a misstatement of a material fact. Material fact is defined by referring to its effect. It is a fact which would signifi-

cantly affect or would reasonably be expected to have a significant effect on the market price or value of the securities. What will be considered a significant effect, and what will indicate the existence of a material fact with all of its implications, is not specified. *National Policy No. 40* ("*Policy*") deals with the issue of materiality in the context of disclosure. The *Policy* discusses and defines "material information":

> Material information is any information relating to the business and affairs of an issuer that results in or would reasonably be expected to result in a significant change in the market price or value of any of the issuer's securities.
>
> Material information consists of both material facts and material changes relating to the business and affairs of an issuer.

The *Policy* adds that:

> The materiality of information varies from one issuer to another according to the size of its profits, assets and capitalization, the nature of its operations and many other factors.

And that:

> It is the responsibility of each issuer to determine what information is material according to the above definition in the context of the issuer's own affairs.

What constitutes a significant effect on the market price is not dealt with in either the *Policy* or the *ASA*. A change of $0.10 for shares trading at $250 is probably not considered significant, but a change of $0.10 is likely to be significant for shares trading at $0.25. The extremes do not present real problems of disclosure. It is the cases between the extremes that create problems.

The *Policy* urges the issuer to consult with the relevant securities regulator (as defined in the *Policy*[78]) when they are in doubt about disclosure. The *Policy* provides a non-exhaustive list of events that should be disclosed.[79] Issuers must remember that the issue of materiality is affected by subjective considerations.[80] It is different in every case, and it is the responsibility of the issuer to determine what is material to their corporation.[81]

The Statutory Defences

There are statutory defences available to directors in the event of misrepresentations in circulars. These defences are based on reasonable investigations and reasonable grounds to believe. Any examination of these defences must also include a consideration of what constitutes a reasonable investigation and what constitutes reasonable grounds to believe. In the context of securities regulation, there are two seminal cases, both are American. As demonstrated, the American and Canadian policies and statutory provisions regarding disclosure are very similar. Therefore, these American cases have persuasive power in Canada.

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78. *National Policy No. 40*, section C.

79. *Ibid.*, section D.

80. *Ibid.*

81. *Ibid.*

Escott v. *BarChris Construction Corporation*[82] considered the efforts directors must make to satisfy the requirements of a reasonable investigation. In *Escott*, the corporate defendant had filed a prospectus-type document containing a number of misrepresentations. To determine the issue of the directors' liability, the Court considered the position held by each director and the access they had to information relevant to the prospectus.[83] The Court stated that the extent of the investigation required will, in part, depend on this access.[84] The greater the access, the more in-depth the investigation must be.[85] Liability will not be avoided if the director did not investigate and merely relied on others to supply accurate data.[86] The Judge criticized in-house counsel, who was also a director, for failing to review contracts that were readily available, and for his failure to insist that the minutes of the executive committee's meetings be produced, when doing so was well within his authority. The Court stated that, while it would be unreasonable to expect the directors to conduct an independent audit of the corporation's affairs, a review of

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82. *Escott* v. *BarChris Construction Corporation*, 283 F.Supp. 643 (S.D.N.Y. 1968).

83. *Ibid.* at 686.

84. *Ibid.*

85. *Ibid.*

86. *Ibid.*

those matters that are easily verifiable is not unreasonable.[87]

Every case will be decided on its facts. Though it is clear that the access a director has to information will be compared to the use they actually made of that access during the investigation. If it appears that the director neglected readily available opportunities to be more thorough, they will be found liable in the event of a misrepresentation. It must be emphasised that reliance on others to supply accurate data for the non-expert portions of the prospectus is not enough to establish the statutory defence. The data must be verified if verification is available.[88]

The second case, *Feit* v. *Leasco Data Processing Equipment*,[89] dealt with the efforts required from directors to satisfy the prerequisites of the defence of due diligence. The defendant corporation had attempted a take-over of Reliance Insurance Co. This bid involved an exchange of the defendant's securities for those of the target corporation. As required, the defendant filed a registration statement which is similar in content and purpose to a prospectus. The registration statement omitted mention of an unregulated surplus fund held by the target corporation. There was, then, a misrepresentation in the registration statement. The

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87. *Ibid.* at 690.

88. *Ibid.* at 686.

89. *Feit*, *supra* note 57.

Court adopted the views of Judge McLean, the Judge in the *Escott* case, and restated that an independent, duplicate investigation is not required, but:

> The defendants were expected to examine those documents which were readily available.[90]

And:

> What constitutes 'reasonable investigation' and a 'reasonable ground to believe' will vary with *the degree of involvement of the individual, his expertise, and his access to the pertinent information* and data.[91] [emphasis added]

This statement of law encompasses the notion that there will be different burdens for different directors with varying personal and professional attributes. This distinction will be particularly pronounced when comparing inside directors and outside directors:

> Inside directors with intimate knowledge of corporate affairs and of the particular transaction will be expected to make a more complete investigation and have more extensive knowledge of facts supporting or contradicting inclusion in the registration statements than outside directors ... Barchris [sic] imposes such stringent requirements of knowledge of corporate affairs on inside directors that one is led to the conclusion that liability will lie in practically all cases of misrepresentation. *Their liability approaches that of the issuer as guarantor of the accuracy of the prospectus.*[92] [emphasis added]

In summary, the directors will be required to utilize the access they have to the pertinent data. It will be their

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90. *Ibid.* at 577.

91. *Ibid.*

92. *Ibid.*

duty to verify, having regard to their access to data, the information they are given. They must not be lax or careless.[93] It is the clear intent of the legislature that the various parties who are put at risk by the statute should endeavour to avoid liability and present the investor with a clear, truthful, and complete narrative of the major components of the transaction in issue.

The standard of quality for the disclosure in a prospectus and the standard of quality of disclosure in a circular can be treated as the same. As a result, the comments of the Courts in *Escott* and *Feit* will form the basis of the discussion to follow wherein the burden on the directors preparing a directors' circular is considered.

DIRECTORS' DUTIES IN THE PREPARATION OF CIRCULARS

Each item in the directors' circular contains instructions to aid in the preparation of the circular. Those instructions describe the required contents, and, in some cases, they describe the steps that are to be taken in obtaining the required information. In this discussion it will be assumed that, where these instructions appear to place conditions on the quality of disclosure, they are to be treated as examples of the application of the burden dis-

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93. *Ibid.* at 568.

cussed. They are not treated as independent standards to be substituted for that burden.[94]

Contents of the Directors' Circular

Any circular or notice that is required under the *ASA* is to be completed clearly. The information is to be divided into subject headings with appropriate titles. All numbers are to be stated as figures. If possible the information is to be presented in tabular form. No responses are required for inapplicable items. Negative answers need not be given unless the Form expressly requires such a response, and the items may be presented in an order other than the order specified in the Form.[95] The directors' circular must comply with Form 32.[96] The completion of the directors' circular will be governed by these directions.

The directors' circular, as provided for in Form 32, is divided into 18 Items. Item 1 requires the name of the

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94. See: *First City Financial Corp. Ltd.* v. *Genstar Corp. et al.* (1981) 33 O.R.(2d) (Ont. C.H.J.) 631 at 645 for an example of a similar interpretation.
If, however, this interpretation of the Form is incorrect, in the end the burden on the directors remains unchanged. For example, if the Item requires disclosure without qualification, the directors will, nonetheless, be excused from liability if they make a reasonable investigation into the facts. If the Item requires disclosure subject to the qualification of reasonable inquiry, the directors will be free of liability if they make that reasonable inquiry. In both cases, compliance with the standard derived in the thesis is the key to avoiding liability.

95. *ASCR*, s.181.9.

96. *ASCR*, s.178.

offeror. Item 2 requires the name of the offeree. Item 3 requires the names of the directors of the offeree. These three Items are administrative in nature, and they require no further elaboration.

Item 4 is entitled "Ownership of Securities of the Offeree Issuer." The instructions require:

> [A statement] of the number, designation and the percentage of outstanding securities of any class of securities of the issuer owned or over which control or direction is exercised by each director or senior officer of the issuer and, if known after reasonable inquiry, by
> (a) each associate of a director or senior officer of the issuer,
> (b) by any person or company holding more than 10% of any class of equity securities of the issuer, and
> (c) any person or company acting jointly or in concert with the issuer,
> or, in each case where none are so owned, directed or controlled, a statement to that effect.[97]

At first it seems there are two classes of information and two levels of diligence required to satisfy this Item. That is, the requirement for disclosure of information regarding the holdings of directors and senior officers is not qualified by an obligation to make a reasonable inquiry. The disclosure of the other information demanded is subject to that obligation. Arguably, this leads to the conclusion that the required information can be divided into two classes: one class that does not require an investigation and the other class that does. If it is accepted that there are two classes of information, the level of diligence

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97. In this Item the term "issuer" refers to the offeree corporation.

required from the directors is, nonetheless, the same for either class. The directors' access to the two categories of information is a vital factor in determining whether or not they have satisfied the burden of investigation placed on them. Based on the guidance given by *Escott* and *Feit*, it follows that, for the first class of information, having regard to the nature of the data involved (publicly available information on shareholders), and the access that the directors have to this information, an independent and complete investigation on the part of the directors is appropriate. It must also be noted that the directors and senior officers owe a fiduciary duty to the corporation, and this duty would require them to be forthright and honest in disclosing their holdings.

The instructions for the second class of information repeat the requirement found in *Escott* and *Feit* that a reasonable inquiry be made. The instructions do not alter the standard required. The directors should be guided by the comments in *Escott* and *Feit*: the access they have to the data, the use they make of that access, and their expertise will determine whether or not they have satisfied the conditions precedent for the statutory defence. Because much of the information for this second category will be received from others it must be verified to the extent that is possible.

Item 5, "Acceptance of Take-Over Bid", requires that, after reasonable inquiry, a statement is to be made naming every person or company listed in Item 4 that has accepted or intends to accept the take-over bid. The circular must also report the number of securities those persons and companies have tendered, or intend to tender to the take-over bid.

The condition of "after reasonable inquiry" used in this Item merely reiterates the governing standard. As with the information regarding securities holdings, the directors must take full advantage of their access to information. Verification of information received from others, where possible, will be an important consideration in determining if the burden has been met.

Item 6, is labelled "Ownership of Securities of Offeror." If the offeror is an issuer[98] then the circular must state the details of the ownership of, or control over, the offeror's securities by the offeree corporation."[99] The circular must state the ownership of, or control over, the offeror's securities by directors and senior officers of the offeree.[100] And, "... [where] known after reasonable

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98. *ASA*, s.1(j):
"issuer" means a person or company that (i) has outstanding securities,
(ii) is issuing securities, or
(iii) proposes to issue securities.

99. *ASCR*, Form 32, Item 6(a).

100. *Ibid.*

inquiry...", the circular must also report the ownership of or control over the offeror's securities by associates of the directors and associates of the senior officers of the offeree.[101] A statement on the ownership of or control over the offeror's securities by any person or company that holds more than 10% of any class of the offeree's securities is required.[102] And the ownership of or control over the offofferorsecurities exercised by any person or company acting jointly or in concert with the offeree must also be reported.[103] If in any of these cases the response is that none of the offeror's securities are held, then a statement to that effect must be made.[104]

The burden on the directors in this Item is the same as in Item 4. They must take full advantage of their access to information during the investigation. They must have regard to the two classes of information and the level of access they have to that information. The better their access is the stricter the requirements for a reasonable inquiry become.

Item 7, is entitled "Relationships Between the Offeror and the Directors and Senior Officers of the Offeree Issuer." The instructions require that the circular:

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101. *ASCR*, Form 32, Item 6(b)(i).

102. *ASCR*, Form 32, Item 6(b)(ii).

103. *ASCR*, Form 32, Item 6(b)(iii).

104. *ASCR*, Form 32, Item 6(b).

State

(a) the particulars of any arrangements or agreements made or proposed to be made between the offeror and any of the directors or senior officers of the offeree issuer,

(b) the particulars of any payment or other benefit proposed to be made or given by way of compensation for loss of office or as to their remaining in or retiring from office if the take-over bid is successful, and

(c) whether any directors or senior officers of the offeree issuer are also directors or senior officers of the offeror or any subsidiary of the offeror and identify those persons.

This Item requires disclosure of what may otherwise be considered confidential and personal matters between the directors, the senior officers, and the offeror. In light of the principle of full, fair, and plain disclosure, this information may be vital to investors. Investors may consider the existence of a generous severance package or employment contract benefiting an officer or director an important matter when they are interpreting the information supplied by those parties. The burden on the directors remains the same. They must make use of their position and expertise to make an appropriate inquiry into the information required. Those officers or directors who may be tempted to withhold this information should be reminded of their duties to the corporation arising under law and by virtue of their employment. Notwithstanding this, if an officer or director chooses to mislead the inquiry it is unlikely that the investigating directors would be liable

for the misrepresentation if their inquiry was otherwise thorough.[105]

Item 8, is called "Agreement Between Offeree Issuer and Officers and Directors." This Item requires a report of the details of any existing or proposed agreements for compensation for loss of position or compensation for remaining with the offeree in the event the take-over bid is successful. This Item requires a report on all golden, silver, or other parachutes. The directors will have virtually unhampered access to this information. Accordingly, to ensure that all relevant information is disclosed, the burden on the directors will be high. For all intents and purposes, a complete and independent inquiry is expected.

Item 9, deals with the "Interest of Directors and Senior Officers of the Offeree Issuer in Material Contracts of the Offeror." This Item requires, as the title suggests, a statement as to whether or not the directors, senior officers, or the associates of the directors or senior officers of the offeree have interests in any "material contracts"[106] of the offeror. The Item also requires a

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105. To vindicate the directors, the misinformation would have to be sufficiently artful that its falsehood would not be apparent if it were subjected to the degree of verification that the directors were in position to subject it to. If the directors do not verify the information they are given they will fail to meet the requirements of the defence.

106. This term is not defined in the *ASA*, *ASCR* or the *ABCA*. In *The New Shorter Oxford Dictionary* (1993), s.v.

(continued...)

report, if the information can be discovered after reasonable inquiry, as to whether those people or firms that hold 10% or more of any class of the offeree's securities have interests in a material contract to which the offeror is a party. In either case, particulars of the nature and extent of the party's involvement must be given. It must be noted that this second aspect of the Item requires the report of information known to the "... directors *or senior officers* of the offeree issuer ...." [emphasis added]

The observations for this Item are, for the most part, the same as for Item 4 above. However, the requirement that the senior officers' knowledge be included implies a specific duty on the part of the senior officers to make reasonable inquiries and to report their findings to those who are assembling the circular. The directors have a degree of authority over the officers. The directors must make use of this authority to ensure that the officers use their access to information and that the officers make use of their expertise when analyzing that information. A failure on the part of the directors to enforce this standard on the officers will be a failure on the directors' part to satisfy the burden placed on them as directors.

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106. (...continued)
"material" ... important, essential, relevant.
In the context with which we are dealing, this definition appears to be appropriate. That is, the Form requires the disclosure of interests in contracts that are important or essential to the offeror and not those of little or no consequence.

Item 10, is entitled "Trading by Directors and Officers." This Item requires a report of the trading activity in the offeree's securities by the directors and senior officers of the offeree. In addition, if known after reasonable inquiry, it requires a statement of the details of trading in the offeree's securities by the associates of the directors and senior officers of the offeree. It calls for a report of the trading activity in the offeree's securities by any companies or persons that hold more than 10% of any class of the offeree's securities. And there must be a report of the trading activity in the offeree's securities by any person or company acting jointly or in concert with the offeree. The information given must include the prices and the dates of the transactions. The circular must also:

> Disclose the number and price of securities of the offeree issuer of the class of securities subject to the bid or convertible into securities of that class that have been issued to the directors and senior officers of the issuer during the 2-year period preceding the date of the circular.

This is a situation involving two categories of information. The standard for the required investigation of the trading by directors and senior officers will be much higher than for the trading of the second group due to the access the directors have to this information. As always, the extent of a satisfactory investigation will be governed by the access and expertise of those making the investigation.

Item 11, "Additional Information":

> If any information required to be disclosed by the take-over bid circular prepared by the offeror has been presented incorrectly or is misleading, supply any additional information within the knowledge of the offeree issuer that would make the information in the circular correct or not misleading.

This Item requires the directors to make a careful review of the take-over circular. A review of the contents of the take-over circular reveals that there are Items that may present a need for correction.

The contents of a take-over bid circular are stipulated by Form 31.[107] Item 13 of that Form, "Material Changes in the Affairs of the Offeree Issuer", requires:

> [A statement] of the particulars of any information *known* that indicates any material change in the affairs of the offeree issuer since the date of the last interim or annual financial statements of the offeree issuer. [emphasis added]

Considering the directions contained in *National Policy No. 40* which deal with the issue of materiality, this Item could cause some concern for the directors of the offeree when preparing their circular. The offeror will naturally wish to put a spin on the information that will make it more advantageous to them; the directors of the offeree will want to show an equally advantageous side of the information. The situation is further complicated by the use of the term "known" in Item 13 of the take-over bid circular. *The New Shorter Oxford Dictionary* defines "know" as "to be aware of

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107. *ASCR*, s.177.

(a fact)."[108] In the atmosphere of a take-over, the temptation to influence the outcome through a casual use of the idea of "known" and the desire to make partisan use of the information available may be very strong. Short of misleading the security holders,[109] there is potential for a difference of opinion as to whether or not a change is material. It follows that the offeree directors must review the offeror's submission in this Item with care and, if they believe any of the information disclosed is:

> ... [P]resented incorrectly or is misleading, they must supply the additional information *within the knowledge to the offeree issuer* that would make the information in the circular correct or not misleading. [emphasis added]

Item 11 of the directors' circular places a specific onus on the directors to ensure that the take-over bid circular does not mislead security holders or present incorrect information. The directors are placed in position that requires them to use their expertise and their positions to protect the offeree security holders from misleading or incorrect information given by the offeror. This responsibility is particularly onerous when the offeror is considering a going private transaction[110] to follow the take-over.

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108. *The New Shorter Oxford Dictionary* (1993), s.v. "know".

109. Making misleading statements is prohibited under *ASA*, s.164(1)(a).

110. *ASCR*, s.170(a):

(continued...)

If this is the case, the take-over bid circular must contain a summary of a valuation of the offeree and an outline of every prior valuation of the offeree that was made within 24 months of the date of the take-over bid.[111] It is highly likely that this valuation will be controversial. The underlying assumptions, the models used, and the accounting practices utilized are just three of a large number of the elements of the valuation that affect its outcome and, accordingly, the apparent adequacy of the consideration being offered. The burden on the directors, in light of their informational advantages over the offeree security holders, to review and, if required, refute the offeror's

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110. (...continued)
"going private transaction" means an amalgamation, arrangement, consolidation or other transaction proposed to be carried out by an insider of an issuer as a consequence of which the interest of the holder of a participating security of the issuer in that security may be terminated without the consent of that holder and without the substitution therefor of an interest of equivalent value in a participating security of:
(i) the issuer;
(ii) a successor to the business of that issuer; or
(iii) another issuer that controls the issuer,
but does not include the acquisition of participating securities pursuant to a statutory right of acquisition.

111. *ASCR*, s.171(2).

valuation will be high. This added responsibility must not be neglected when the contents of this Item are prepared.[112]

Item 12, "Material Changes in the Affairs of the Offeree Issuer", calls for a statement of any information known to any of the directors or senior officers of the offeree about material changes[113] in the affairs of the offeree since the last published interim or annual financial statements.

Note that Item 12 specifies that the report be of information known by senior officers and directors. This supplements the duty already imposed on the offeree issuer to disclose material changes.[114] The senior officers and directors will be under a duty to make inquiries commensurate with their position and expertise to discover informa-

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112. The role of the directors' circular as a source of information is referred to in *Sparling*, *supra* note 8 at 102. It is an accepted principle of disclosure that under some circumstances the directors' circular may in fact remedy disclosure shortcomings in the take-over bid circular. *Re Canfor Corp.* (1995) 6 C.C.L.S. 287 (O.S.C.B) at para 25.

113. *ASA*, s.1(k.1):
"material change", when used in relation to the affairs of an issuer, means a change in the *business, operations or capital* of the issuer that would reasonably be expected to have a significant effect on the market price or value of any securities of the issuer and includes a decision to implement the change made by the board of directors of the issuer or by senior management of the issuer who believe that confirmation of the decision by the board of directors is probable. [emphasis added]

114. *ASA*, s.118(1).

tion that may constitute a material change.[115] They must also make an appropriate inquiry into information previously known, but not then considered material, to determine if, in light of the take-over bid, it is now material. A review of prior notices of material change to determine if the take-over bid changes the effect of those previous disclosures should be also be undertaken. The contents of *National Policy No. 40* must be kept in mind. What is material for this firm, particularly in light of the take-over bid, must be carefully considered.

Item 13, "Other Information", requires a report of "... any other information ...", that is not already disclosed, but that is known to the directors and that would reasonably be expected to affect the decision of the security holders to accept or reject the take-over bid.

Item 13 is a catch-all section. Anything of importance that has not yet been noted must now be noted. The only restriction placed on this section is that the information be known to the directors. It has already been established that there is an onus on the directors to make inquiries. Therefore, the directors cannot be satisfied by a review of their pre-existing knowledge, they must make inquiries and obtain the information to which they have access. The nature

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115. See: *Re Pezim et al. and Superintendent of Brokers et al.*(1994), 114 D.L.R. (4th) 385 (S.C.C.) for comments dealing with the duty of directors to make a reasonable inquiry into the existence of material changes in the context of insider trading.

of the information sought can be determined by the effect specified in the Item. That is, information that would "... reasonably be expected to affect the decision of the security holders ...." A plain language interpretation of this requirement implies that information about the general state of the economy, interest rate forecasts, anticipated investment opportunities, and an endless list of other items, would have to be investigated and commented on. However, issuers are excused from reporting and commenting on general conditions in the economy and matters that effect their industry as a whole.[116] The requirements of Item 13 will be satisfied by reference to information that is unique to the offeree, or information that has an effect on the offeree that is different from its effect on other firms in the same industry.

Item 14, is entitled "Recommending Acceptance or Rejection of A Take-Over Bid." The circular must contain either a recommendation to accept or reject the take-over bid and give reasons for the recommendation. Or, the circular may make no recommendation and contain a statement of the reasons why no recommendation is being made. If the board of directors intends to make a recommendation in the future, the circular is to state that fact. The board of directors may then, if they wish, advise the security holders not to tender until that recommendation is made. It is this portion

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116. *National Policy No. 40*, section D.

of the directors' circular for which the independent committee, previously discussed, will be responsible. It is also this Item that will be most likely to result in an individual director or officer releasing their own circular. The independent committee will have been charged with the responsibility of determining the acceptability of the take-over bid. They will bring their recommendation to the full board of directors. Barring any dissention, the recommendation would then be adopted by the board as the recommendation of the board as a whole.

Whether the board of directors makes an explicit recommendation for rejection or acceptance, or the board of directors declines to make a recommendation, they must give reasons. The adequacy of these reasons is an issue that will arise. Making a reasonable construction of the circular and, having regard to the law on the duties of the directors, it follows that these reasons must be made on information that was obtained through appropriate inquiries. The information must have been subjected to an appropriate level of review. The use of experts seems reasonable if the recommendation is to be based on valuation issues or legal prohibitions. In addition, the use of the independent committee to formulate the board's position, by removing the taint of conflict of interest, will add credence to the position adopted.

Item 15, "Response of Offeree Issuer", the circular is to:

(1) Describe any transaction, board resolution, agreement in principle or signed contract of the offeree issuer in response to the bid.
(2) Disclose whether there are any negotiations underway in response to the bid that relate to or would result in one or more of the following:
    (a) a merger or reorganization involving the offeree issuer or a subsidiary or any other extraordinary transaction;
    (b) the purchase, sale or transfer or a material amount of assets by the offeree issuer or a subsidiary;
    (c) an issuer bid for or other acquisition of securities by or of the offeree issuer;
    (d) any material change in the present capitalization or dividend policy of the offeree issuer.
(3) If there is an agreement in principle, give full particulars.

This Item requires disclosure of any defensive steps the board of directors intends to take. A discussion of such defences is deferred a later point. At this time, it will only be noted that the circular must disclose these details. If the board of directors chooses to implement a defence at a later time, that decision will constitute a change to the contents of the circular and a notice of that change will have to be prepared and distributed.

The wording of Item 15(1) implies a very heavy burden of inquiry and disclosure. "... Any transaction, ... of the offeree issuer *in response to the bid*." [emphasis added] This disclosure will be subject to considerations of

materiality.[117] Accordingly, while a contract may have been entered into for the printing of the directors' circular in response to the bid, it is unlikely that this is a material item, and it is unlikely that there is a need to disclose it. The exception of materiality aside, the directors will be required to make an appropriate inquiry. In this case, an appropriate inquiry will require the use of all the power the directors have to access information. The disclosure must include all transactions, etc. out of the normal course of business that can be said to be in response to the bid. It may be tempting to shade the facts of a transaction and conclude that it was not entered into in response to the bid and therefore need not be disclosed. However, the risk of liability and the principles underlying disclosure makes this sort of behaviour unacceptable. The directors will have to be diligent to avoid being deterred by those who would prefer not to disclose certain transactions.

The burden on the directors to disclose board resolutions made in response to the bid is close to absolute. This information is instantly available to them, and the purpose of the resolution will, short of incompetence or studied obfuscation on the part of the directors, be immediately apparent.

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117. This restraint is premised on the idea that the directors are conducting themselves in a manner intended to avoid civil or criminal liability. Therefore the definition of misrepresentation restricts this item of disclosure to material facts only.

Item 15(1) does not cover pre-existing resolutions made in anticipation of take-over bids in general, but it does cover pre-existing resolutions that were made in anticipation of this take-over bid. Existing poison pills implemented without regard to this specific take-over threat need not be disclosed. This is consistent with the legislative scheme that requires the corporation to file notices of material change.[118] The offeror and interested parties will have another easily accessed source of information regarding pre-existing pills.

Item 15(2) concerns "negotiations" that are underway in response to the bid. Negotiation is not defined in any of the relevant statutes. The *The New Shorter Oxford Dictionary* defines the verb "negotiate" as to "confer with others in

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118. *ASA* s.1(k.1):

> "material change", when used in relation to the affairs of an issuer, means a change in the business, operations or capital of the issuer that would reasonably be expected to have a significant effect on the market price or value of any of the securities of the issuer and includes a decision to implement the change made by the board of directors of the issuer or by senior management of the issuer who believe that confirmation of the decision by the board of directors is probable.

ASA s.118(1)(a) requires the issuer to file a copy of the news release regarding the material change and (b) a copy of the notice of material change with the Executive Director of the Commission.

A review of the news releases shows that implementation of "share-holders' rights plans" or "poison pills" are commonly accepted as material changes and it is therefore the practice that they would be disclosed.

order to reach a compromise or agreement."[119] For purposes of contrast, the verb "discuss" is defined as to "hold a conversation about."[120] It follows from this, and appropriately so, that negotiations begin when the animating purpose of the parties to the exchange is to reach an agreement. Up to that point it is merely a discussion. The directors must disclose those interactions with others that are aimed at entering into a contract.

Item 15(2)(a) requires disclosure of negotiations towards, among other things, extraordinary transactions that are being considered in response to the bid. Extraordinary transaction is not defined in the *ASCR*, the *ASA*, or the *ABCA*. The *New Shorter Oxford Dictionary* defines "extraordinary" as "unusual or remarkable; out of the usual course."[121] This definition makes it clear that if there are any unusual or out of the ordinary transactions being contemplated on the part of the offeree issuer or its subsidiaries they must be disclosed. Mergers or reorganizations involving the issuer or subsidiaries that are being negotiated must also be disclosed. Item 15(2)(b) requires disclosure of negotiations aimed at consummating a deal for a purchase or sale or transfer of a "material amount" of assets. The term

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119. *The New Shorter Oxford Dictionary* (1993), s.v. "negotiate".

120. *Ibid.* s.v. "discuss".

121. *Ibid.* s.v. "extraordinary".

"material amount" is not defined. In keeping with the policy of disclosure that pervades this whole area it is submitted that "material amount" will be any sale or purchase, etc. that is reasonably likely to result in a material change.

Item 15(2)(c) requires disclosure of negotiations relating to an issuer bid[122] or the acquisition of the issuer's securities by another. This requires the target firm to disclose negotiations that are aimed at getting another bidder involved in the take-over. The final sub-item is directed at alterations to the present capitalization of the target or changes in dividend policy. Changes in capitalization will include material changes in the debt load. As with other parts of Item 15, the purpose here is to require disclosure of the defences to the take-over that have been undertaken or that are being seriously considered by the board of directors of a target corporation.

Item 16 is labelled "Approval of Directors' Circular." This Item requires a statement that the contents of the directors' circular have been approved by the directors of

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122. *ASA* s.131(k):
"issuer bid"
(i) means an offer to acquire or redeem securities of the issuer made by that issuer to any person or company that is in Alberta or that is a holder in Alberta, and
(ii) includes a purchase, redemption or other acquisition of securities of the issuer by the issuer from that person or company,
but does not include an offer to acquire or redeem debt securities that are not convertible into securities other than debt securities.

the offeree issuer, and it requires a statement that the delivery of the directors' circular has been authorized by the offeree's directors. The authorization and approval need not be unanimous. Clearly this approval and authorization must not only be stated to exist, but it must, in fact, actually exist.[123] A record of the resolutions in the minutes of the board will be required.

Item 17 is "Financial Statements." If the directors' circular contains unaudited financial statements it must also contain a report by the offeree's chief financial officer stating whether, in his opinion, the "... financial statements present fairly the financial position of the offeree issuer and the results of its operations for the period under review." The duties of the directors in this regard will not require them to make a complete and independent audit of the offeree's financial affairs. They will be required, however, to satisfy themselves that the data used and the conclusions drawn are accurate.[124] Specifically, they will have to demonstrate that, on the basis of their

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123. See: *Karoles* v. *Alberta Securities Commission* (1995) 169 A.R. 4 (Alta. C.A.) for an example of a case where a certificate purporting to be authorized was attached to a prospectus when in fact the certificate was not authorized.

124. See: *Escott*, *supra* note 82 at 685.

inquiries, there was no reason to think there was a misrepresentation.[125]

Item 18, "Certificate", the text of the certificate is intended to draw the attention of those who receive the circular to the penal consequences for misrepresentation, and it is intended to draw attention to the requirement that all fees in relation to a document have to be paid before the document is considered to be properly filed.

CHAPTER SUMMARY

This chapter showed that the take-over process is controlled by a regulatory system involving specialized statutes, regulations, rules, policies, blanket and discretionary orders and specialized boards and commissions. The statutes that govern incorporation will dictate the general duties of the directors in the context of a take-over. The securities statutes and other regulatory devices will fur-

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125. Is the Chief Financial Officer an "expert" within the meaning of *ASA* ss.168 & 169? "Expert" is not defined, however *ASCR* s.85(1) deals with the consents of those who would be considered experts and describes them as:

> ... [A]ny solicitor, auditor, accountant, engi-neer, appraiser or any other person or company, whose profession gives authority to a statement or opinion made by him ....

If the CFO is a person whose profession gives authority to his opinion, then yes, he is an expert. Accordingly the defences for misrepresentations made in expert portions of the circular will be available. If they are not such a person then this opinion must be subjected to the scrutiny required to satisfy the defence for misrepresentations in non-expert portions of the circular.

ther refine the controls on the conduct of the directors. Considerable attention was given to the burden placed on the directors of a target firm to ensure the quality of information contained in the directors' circular.

To gain a full appreciation of this burden the American and Canadian regimes were compared, and it was concluded that the American situation offered an appropriate guide to the inquiry. It was determined that directors will be held to a standard that is delineated by their access to information, their expertise, and the use they make of that access and expertise. Failure to fully utilize these attributes will result in a finding that the preconditions for the statutory defences against liability have not been satisfied. The disclosure required by each Item in the directors' circular was examined.

This partial analysis of the legal regime, that is those duties that the directors of a target firm are required to make, will be followed in Chapter 4 by a similar review of the effect of the *Canada Business Corporations Act* on the take-over process. Chapter 4 will complete the consideration of the responses that a target firm's board of directors must make to an uninvited take-over bid. It will also include an analysis of the interests that the legal regime, to that point in the analysis, is advancing.

CHAPTER 4

THE *CANADIAN BUSINESS CORPORATIONS ACT* AND THE TAKE-OVER PROCESS

INTRODUCTION

The thesis and its purposes were discussed in Chapter 1. The theory of the firm was developed and from that theory a prescriptive model of the firm was derived in Chapter 2. Chapter 3 reviewed and analyzed the law governing the take-over process in general and the duties of the directors of a target firm in particular. This chapter considers how federal statutes affect the take-over process with a continuing emphasis on mandatory responses by the board of directors. When the analysis developed in this chapter is combined with that in Chapter 3 it will be possible to determine the interests that the legal regime advances in the context of the mandatory responses from the board of directors.

Chapter 5 will consider the optional and prohibited responses of the directors. The thesis will conclude by considering the fit of the legal regime to the financial model.

THE *CANADIAN BUSINESS CORPORATIONS ACT* AND THE TAKE-OVER PROCESS

The Alberta *Securities Act*[1], ("*ASA*"), is a provincial statute. The jurisdiction conferred by that Act is restricted to matters taking place within Alberta. When the security holders affected by a take-over bid reside outside Alberta the parties must look to the rules of the jurisdiction in which the security holders reside to determine the appropriate procedures to follow.[2] Corporations are also bound by the statutes under which they

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1. *Securities Act*, S.A., 1981, c.S-6.1, as amended.

2. The courts have generously interpreted the jurisdiction of the provincial securities statutes. See: *Regina* v. *McKenzie Securities Limited, et al.* (1966), 55 W.W.R. 157 (Man. C.A.) where the Court upheld a conviction for trading in securities without being registered in Manitoba. The transaction in question was promoted from Toronto through the mail and over the telephone. At no time was the dealer present in Manitoba. It was held that, nonetheless, the transaction had taken place in Manitoba, and accordingly, the conviction was proper.

See also: *Gregory & Company* v. *The Quebec Securities Commission, et al.* [1961] S.C.R. 584 (S.C.C.). In this case the Supreme Court of Canada upheld the validity of certain enforcement actions taken by the Quebec Securities Commission against Gregory. The enforcement actions were taken when Gregory continued to publish and circulate an investment newsletter to clients located outside Quebec following the cancellation of Gregory's license to act as a broker in Quebec. The Supreme Court upheld the actions of the Commission in holding that Gregory was trading in securities within Quebec notwithstanding all the relevant clients were located outside the province. In reaching its conclusion, the Court held, at 588:

> The paramount object of the Act is to ensure that persons who, in the province, carry on the business of trading in securities or acting as investment counsel, shall be honest and of good repute and, in this way, to protect the public, in the province and elsewhere.

were incorporated no matter where their security holders reside. Each province has its own statute governing incorporation, and there is, as well, a federal statute under which corporations may be established.[3] This federal statute controls certain aspects of the take-over process, regardless of where in Canada the security holders are located, so long as the target corporation is a *CBCA* corporation.[4]

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3. There is an issue as to the constitutionality of the federal corporations statute, the *Canada Business Corporations Act*, R.S.C., 1985, c. C-44, as amended. The provincial power to incorporate companies comes from s. 92(11) of the *Constitution Act, 1867*. It provides that the provinces may legislate with regard to companies with provincial objects. The federal power to incorporate is found in judicial interpretation. Specifically, s.91, the "peace, order, and good government" section has been relied upon to justify federal laws involving incorporation. In short, the federal parliament can do anything the provinces cannot. The provinces cannot legislate with regard to inter-provincial commerce, therefore, the federal parliament can. B.L. Welling, *Corporate Law in Canada: The Governing Principles*, 2d ed. (Toronto: Carswell, 1991) at 2 & 9.

4. There is a long running debate in Canada over the desirability of the federal government taking over the administration of securities from the provinces. Both the provinces and the federal government have the authority to enact securities statutes. It has been the practice of the courts to uphold the validity of the provincial statutes even in the face of overlapping but not conflicting federal legislation. As both the provinces and the federal government have a constitutional basis for enacting regulations, the debate generally focuses on trade-off between the efficiencies to be gained by federal control against the adaptability to local conditions that the provincial commissions can provide. M.R. Gillen, *Securities Regulation in Canada* (Scarborough, Ont.: Carswell, 1992) at 51-53.

The federal statute is the *Canadian Business Corporations Act*,[5] ("*CBCA*"), and it applies in all the provinces and territories of Canada. The Act provides for the incorporation of companies, and it contains provisions that govern a limited number of securities-based transactions, including take-over bids.[6] Therefore, consideration must be given to how the federal provisions affect the securities regimes established under the provincial securities acts.

The Incorporation Provisions of the *CBCA*

The *CBCA* provides for the incorporation of companies and uses the statutory division-of-powers model.[7] The stated purposes of the Act are to "... revise and reform the law applicable to business corporations incorporated to carry on business throughout Canada ...."[8] A corporation established under the *CBCA* has the capacities, powers, and privileges of a natural person.[9] These corporations may carry on business throughout Canada.[10] *CBCA* corporations may distribute their

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5. *Canada Business Corporations Act*, R.S.C., 1985, c. C-44, as amended.

6. *CBCA*, Part XVII.

7. *CBCA*, ss.102, 121, and 140.

8. *CBCA*, s.4.

9. *CBCA*, s.5(1).

10. *CBCA*, s.5(2).

securities to the public.[11] And their control structure is the same as that used by corporations established under the *ABCA*.

When performing the duties imposed on them by the statute, directors and officers of *CBCA* corporations must adhere to the same standard of care as do directors and officers of *ABCA* corporations.[12] And, as discussed in Chapter 3, this standard imposes a fiduciary duty on the directors[13] with the corollary that the directors are to avoid conflicts of interest.

A take-over bid creates a potential for conflict of interest between the duties of inside directors',[14] as directors, and their interests as officers and employees of the corporation. The advice regarding the use of an

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11. This power is implicit in *CBCA*, ss.2(6), 2(7) & 193 and throughout Part XVII.

12. *CBCA*, s.122(1).

13. *CBCA*, s.2(1):
"corporation" means a body corporate incorporated or continued under this Act and not discontinued under the Act.
And:
"body corporate" includes a company or other body corporate wherever or however incorporated.

14. *CBCA*, s.102(2):
... a corporation that has issued securities, any of which were or are part of a distribution to the public and remain outstanding and are held by more than one person, shall have no fewer than three directors, at least two of whom are not officers or employees of the corporation or its affiliates.

independent committee[15] of the directors to consider the appropriateness of the take-over bid will, therefore, apply to *CBCA* corporations in the same manner it was applied to *ABCA* corporations.

The *CBCA* scheme of regulation utilizes two quantitative thresholds of shares being sought in a take-over. The thresholds are 10% of the outstanding securities of the class that is being sought[16] and 100% of that class.[17] The different thresholds trigger different provisions in the Act.

Take-over Bids Under the *CBCA*

A take-over bid under the *CBCA* begins when the shares sought in the bid combined with those already held by the offeror exceed 10% of any class of the offeree corporation's shares.[18] Section 194 defines "offeree corporation" as "... a corporation whose shares are the object of a take-over bid." Corporation is defined in s.2(1) as a corporation incorporated under the *CBCA*. The definition of take-over bid speaks of an offeree corporation, therefore the take-over bid provisions of the *CBCA* apply only when the target corporation is a *CBCA* corporation. They do not apply where

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15. Chapter 3, *supra*, and accompanying text.

16. *CBCA*, s.194.

17. *CBCA*, s.195.

18. *CBCA*, s.194.

the offeror corporation is a *CBCA* corporation but the offeree is not. Take-over bids under the *CBCA* begin at a level that is one-half of the threshold for take-over bids under the *ASA* and other provincial securities acts. Because of this, the provisions of the *CBCA* will overlap with the provisions of the provincial securities acts where a take-over bid is for more than 20% of the outstanding shares of the subject class of securities issued by a *CBCA* corporation.

Take-over Bids Under the *CBCA* for More Than 10% but Less Than 20% of the Outstanding Shares

A take-over bid for a *CBCA* corporation that seeks more than 10% of the shares of the class, but less than 20%, does not trigger the take-over provisions of the *ASA*.[19] The *CBCA* provides the entire regulatory framework within which such a take-over bid will be conducted.

The *CBCA*, like the *ASA*, creates a closed system for take-over bids within its jurisdiction. Bids will be governed by the provisions of the Act unless the Act provides an exemption.

Section 194:

> "exempt offer" means an offer ...
> (b) to purchase shares through a stock exchange or in the over-the-counter market in such circumstances as may be prescribed.

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19. *ASA*, s.131(1)(r); *BCSA*, s.74(1); and *OSA*, s.89(1).

Therefore, like the provincial securities statutes, the *CBCA* provides for take-over bids to be made either through the facilities of a recognized stock exchange or by the circular bid process.[20] The thesis will consider the circular bid process.

Within *CBCA*'s framework, the take-over process is divided into two varieties of bids based on two thresholds of securities previously referenced. There are bids for all the shares of any class[21] and bids for less than all the shares in a class.[22]

When a bid is made for less than all the shares of a class s.196(1) provides that:

> (a) [T]he offeror shall not take up shares deposited pursuant thereto until twenty-one days after the date of the take-over bid;
> (b) the period of time within which shares may be deposited pursuant to the take-over bid or any extension thereof shall not exceed thirty-five days from the date of the take-over bid; and
> (c) if a greater number of shares is deposited pursuant to the take-over bid than the offeror is bound or willing to take up and pay for, the shares taken up by the offeror shall be taken up rateably, disregarding fractions, according to the number of shares deposited by each offeree.

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20. *CBCA*, s.198(3).

21. *CBCA*, s.195.

22. *CBCA*, 196(1).

Section 197 provides that all take-over bids, whether for all or less than all the shares of a class, shall be governed by its provisions.[23]

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23. This section provides that:
(a) [S]hares deposited pursuant to the take-over bid may be withdrawn by or on behalf of an offeree at any time within ten days after the date of the take-over bid;
(b) shares deposited pursuant to the take-over bid shall, if the terms stipulated by the offeror and not subsequently waived by him have been complied with, be taken up and paid for within fourteen days after the last day within which shares may be deposited pursuant to the take-over bid;
(c) the period of time within which shares may be deposited pursuant to a take-over bid shall not be less than twenty-one days after the take-over bid;
(d) if the terms of the take-over bid are amended by increasing the consideration offered for the shares, the offeror shall pay the increased consideration to each offeree whose shares are taken up pursuant to the take-over bid whether or not such shares have been taken up by the offeror before the amendment of the take-over bid;
(e) if the offeror intends to purchase shares to which the take-over bid relates in the market during the period of time within which shares may be deposited pursuant to the take-over bid, the offeror shall so state in the take-over bid circular; and
(f) if the offeror purchases shares to which a take-over bid relates other than pursuant to the take-over bid during the time within which shares may be deposited pursuant to the take-over bid,
(i) the payment other than pursuant to the take-over bid of an amount for a share that is greater than the amount offered in the take-over bid is deemed to be an amendment of the take-over bid to which paragraph (d) applies,
(ii) the offeror shall immediately notify the offerees of the increased consideration being offered for the shares,

(continued...)

Every take-over bid, which must include a copy of the take-over bid circular prepared in accordance with the required form, is to be forwarded to each director of the offeree corporation, to each shareholder of the offeree corporation resident in Canada, and to the Director.[24] The contents of the take-over bid circular are prescribed in the *Canadian Business Corporations Act Regulations*,[25] ("*CBCR*") s.59. Section 60 contains requirements for additional information where the consideration for the shares being sought consists in whole or in part of securities of the offeror or another corporation. The requirements of the take-over bid circular under the *CBCA* are essentially the same as those under the provincial statutes. The precise contents of the take-over bid circular are not germane to this thesis. Specific aspects of the take-over bid circular will be considered as and when it is necessary to illuminate the discussion of the duties of the target firm's board of directors.

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23. (...continued)
(iii) the shares acquired other than pursuant to the take-over bid shall be counted to determine whether a condition as the minimum acceptance has been fulfilled, and
(iv) the shares acquired other than pursuant to the take-over bid shall not be counted among the shares taken up rateably under paragraph 196(1)(c).

24. *CBCA*, s.198(1). The Director is an official appointed pursuant to the provisions of the *CBCA*.

25. *Canada Business Corporations Regulations*, SOR/79-316 as amended.

Under *CBCA*, s.201(1), unless the directors send the directors' circular within 10 days of the date of the take-over bid, the directors are to forthwith notify the offerees and the Director that a circular will be sent. The directors may, at the time the notification is sent, recommend to the offerees that they not tender until they receive the directors' circular. If the directors' circular is not sent within 10 days of the date of the take-over bid, it is to be sent not later than seven days prior to the expiration of the take-over bid, or it is to be sent before the sixtieth day of the bid, whichever is earlier.[26] The directors' circular must comply with the prescribed form.[27] A director of the offeree corporation can dissent from the opinions or positions taken in the directors' circular. If they do so, they must set out in the directors' circular a statement of the reasons for their position.[28]

The form of the directors' circular is found in *CBCR*, ss.68-73. The directors of the offeree corporation shall approve a directors' circular that contains the recommendations of a majority of the directors, and that approval shall be evidenced by the signature of one or more of the directors.[29]

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26. *CBCA*, s.201(4).

27. *CBCA*, 201(3).

28. *CBCA*, s.201(5).

29. *CBCA*, s.203(2).

Circular Bids Under the *CBCA* for More Than 20% but Less Than All of the Shares of the Class

The second situation that arises under the *CBCA* regime is a take-over bid made for more than 20% but less than all of the securities of a class issued by a *CBCA* corporation. The provisions of the *CBCA* examined above apply as they relate to bids for less than all the shares in a class of shares. The provisions of the provincial securities legislation in the provinces where the offeree security holders reside also apply. For example of this situation is an acquiror that wishes to obtain 45% of the outstanding shares of a *CBCA* corporation whose residents all reside in Alberta. In this case the offeror must adhere to the provisions of the *CBCA* and the *ASA*.

This thesis has previously examined the provisions of the *ASA* as they apply to the directors' circular. The situation where only the *CBCA* affects the directors' circular has also been considered. In the situation now under review the offeror and offeree must comply with the requirements of both the federal and provincial regimes. Both regimes require a directors' circular and that it be prepared in accordance with its act, rules, and the form prescribed. Special attention must be paid to the contents of the directors' circular to ensure that the requirements of both regimes are met. Regard must be had for the time limits involved, the certificates, warnings, and methods of execution required under both regimes. A more detailed dis-

cussion of the contents of the directors' circular will be conducted below, but one cause for concern is readily apparent. The *ASA* requires a dissenting director to publish an independent circular if she wishes to communicate her views of the take-over bid to the offeree security holders; the *CBCA* requires the dissenting director to publish her statement regarding the disagreement within the directors' circular. How are these inconsistent provisions to be handled? This apparent difficulty will have to be considered when preparing the directors' circular. It is submitted that the best approach to follow is to comply with both Acts. In the case of the director's dissent, publish a statement of reasons in the directors' circular as required by the *CBCA*, and publish an independent circular as required by the *ASA*.[30] It will be very important to ensure that the positions taken in each document are the same. This rule of thumb can be applied to other areas of inconsistency between the requirements of the *CBCA* and the *ASA*.[31]

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30. The directors may also request an exemption from the *ASA* requirement of a separate circular for individual directors from the *ASC*.

31. *Multiple Access Ltd.* v. *McCutcheon* (1982), 18 B.L.R. 138 (S.C.C.) is authority for the proposition that legislative duplication, without actual conflict or contradiction, is not sufficient to raise the doctrine of paramountcy. Accordingly, otherwise valid provincial legislation will be upheld notwithstanding it covers the same subject matter as does the federal legislation.

Circular Bids Under the *CBCA* for All the Shares of the Class

The final situation to be considered is that which arises when the take-over bid is made for all the shares of the class of the offeree *CBCA* corporation.

CBCA, s.195:

> Where a take-over bid is for all the shares of any class,
> (a) shares deposited pursuant to the take-over bid, if not taken up by the offeror, may be withdrawn by or on behalf of the offeree at any time after sixty days following the date of the take-over bid;
> (b) the offeror shall not take up shares deposited pursuant thereto until ten days after the date of the take-over bid; and
> (c) the offeror, if he intends, shall state in the take-over bid circular that he intends to invoke the right under section 206 to acquire the shares of offerees who do not accept the take-over bid and that the offeree is entitled to dissent and to demand the fair value of his shares.

Because the take-over bid is for more than 20% of the outstanding shares of the class, the provisions of the provincial securities acts are also effective. This situation is best managed by the persons responsible for the preparation of the directors' circular being acutely aware of the requirements and time-lines of all of the regimes with which they are involved. All regimes will require a directors' circular that complies with the requirements of its act, rules, and forms. Fortunately, the directors' circulars under the various provincial statutes and that which is required by the *CBCA* are substantially identical.

Disclosure in a *CBCA* Directors' Circular

Two situations will be analyzed: the situation that arises when only the *CBCA*'s take-over provisions have been triggered; and the situation that arises when the take-over provisions of the *CBCA* and one or more of the provincial securities acts have been activated. In the first case, the requirements of the *CBCA* and the *CBCR* stand on their own. In the second case the provisions of the various regimes must be taken into account.

Disclosure When Only the *CBCA* Applies

When the directors' circular requirements of the *CBCA* stand alone the provisions of the *CBCR*, ss.68-73, and the *CBCA* govern the directors' circular and provide the incentives that determine the appropriate quality of disclosure. Section 250(1) of the *CBCA* provides for penal sanctions in the event of certain errors arising in disclosure:

> A person who makes or assists in making a report, return, notices or other document required by this Act or the regulations to be sent to the Director or other persons that
> (a) contains an untrue statement of a material fact, or
> (b) omits to state a material fact required therein or necessary to make a statement contained therein not misleading in the light of the circumstances in which it was made
> is guilty of an offence and liable on summary conviction to a fine not exceeding five thousand dollars or to imprisonment for a term not exceeding six months or both.
> (2) Where a body corporate commits an offence under subsection (1), any director or officer of the body corporate who knowingly authorized, per-

> mitted or acquiesced in the commission of the offence is a party to and guilty of the offence ... whether or not the body corporate has been prosecuted or convicted.
> (3) No person is guilty of an offence under subsection (1) or (2) if the untrue statement or omission was unknown to him and in the exercise of reasonable diligence could not have been known to him.

Section 250 of the *CBCA* uses the expression "material fact" which is a defined term in other jurisdictions, but it is not defined in the *CBCA*. The meaning of "material fact", in the absence of a statutory definition and in the context of securities regulation, has been considered in American and Canadian cases. The leading case is American: *TSC Industries Inc., et al.* v. *Northway, Inc.*[32]. In that case, the United States Supreme Court formulated a test for materiality.

> The general standard of materiality that we think best comports with the policies of Rule 14a-9 is as follows: An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.[33]

The Ontario Court of Appeal had occasion to consider the meaning of the term "material fact" in the context of the *CBCA* in *Sparling et al.* v. *Royal Trustco Ltd. et al.*.[34] The Court of Appeal noted that "material fact" was not

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32. *TSC Industries Inc., et al.* v. *Northway, Inc.*, 426 U.S. 438 (1976).

33. *Ibid.* at 449.

34. *Sparling et al.* v. *Royal Trustco Ltd. et al.* (1984), 45 O.R. (2d) 484 (C.A.).

defined in the *CBCA*, and, after a review of the *TSC* case, determined that it was appropriate to apply the test from *TSC* to the concept of material fact in the *CBCA*.[35] As a result, in the context of the *CBCA*, a material fact is one in regard to which there is a substantial likelihood that a reasonable shareholder would consider it important in deciding on the action to take.

The *CBCA* prohibits, on threat of penal sanctions, untrue statements of material facts in reports, circulars, etc. that are required by the Act to be sent to security holders.[36] A *CBCA* directors' circular is such a document.[37] In the event the circular contains an untrue statement, there will be no sanction against the parties responsible if they did not know the statement was untrue and could not, with the exercise of reasonable diligence, have known it was untrue.[38] Under *CBCA* the directors of the corporation are expected to satisfy the same standard of conduct in the exercise of their general duties as are directors of corporations incorporated under provincial statutes.[39] These provisions combine to impose the same burden on the directors to ensure accuracy and completeness of circulars

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35. *Ibid.* at 490.
36. *CBCA*, s.250(1).
37. *CBCA*, s.201(1).
38. *CBCA*, s.250(3).
39. *CBCA*, s.122(1).

required under the *CBCA* as is imposed by the provincial statutes in regard to the circulars required under those regimes.

As noted in Chapter 3, the Canadian securities regimes are sufficiently similar to the American regime that American cases can be of great assistance when considering the Canadian statutes. It follows that, in a prosecution under this section of the *CBCA*, a court will, when considering the statutory defence, look for an answer to one of two questions. The first asks if, having regard to the position and expertise of each director considered individually, did the director, in fact, make the inquiries and seek the verification that was available to him. The second asks if the directors would have been able to uncover the untrue statement if they had exercised the powers of investigation and verification that corresponded to their positions and expertise. A positive answer to the first question or a negative answer to the second will result in an acquittal.

Under the provincial regimes, there are statutory civil remedies that affect the burden placed on directors and others to ensure that disclosure is accurate and complete.[40] Specifically they make an investigation by the directors mandatory. The *CBCA* does not contain specific provisions imposing civil liability for misrepresentations in

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40. See for example: *ASA*, s.169(7).

circulars, and accordingly, under the *CBCA*, investigation is not mandatory. It is submitted that, in light of the important role policy plays in securities regulation, the existence of an explicit policy that entitles security holders to reliable and complete information, and the important evidentiary role an investigation will play in a prosecution for a misrepresentation in a circular, it is advisable, nonetheless, to undertake an adequate investigation.

Disclosure When the *CBCA* and Provincial Statutes Apply

The second situation involves a take-over bid that has triggered the provisions of the *CBCA* and one or more of the provincial securities acts. This situation will arise, for example, in the case of a bid for 40% of the outstanding shares of a *CBCA* corporation. The provisions of the *CBCA* have already been discussed. The provisions of the provincial statutes were considered at length above. It is left to consider, in practical terms, the burden placed on the directors of the target firm when preparing the directors' circular in such a situation.

In Alberta, the directors are to exercise the powers of their positions and their expertise to seek verification and make inquiries into the substantive answers that are to be provided. They cannot be passive, but they are not guarantors of the information. This situation does not

change due to the overlap of the *CBCA*'s jurisdiction. The directors must satisfy the burden placed on them by each of the regimes. They can protect themselves by satisfying the more onerous of the concurrent requirements.

In the case of interaction between the Alberta and federal jurisdictions, the directors must consider the two formulations of the concept of "material fact." They must consider those matters that satisfy the criteria of the defined term in the *ASA*, and they must consider those matters that satisfy the intent of the undefined term as it is used in the *CBCA*. The directors can accomplish both tasks by using the test for material fact based on the broader formulation of the term. In Alberta, a material fact is one that "... significantly affects or would reasonably be expected to have a significant effect on the market price or value of the securities."[41] Under the *CBCA*, a material fact is a fact in regard to which there is a substantial likelihood that a reasonable shareholder would consider it important in deciding on the action to take.[42] It appears that the *CBCA* formulation is broader than the Alberta formulation. It follows that if the *CBCA* formulation is satisfied the Alberta formulation will also be satisfied.

Another aspect of the overlapping jurisdictions that should be considered is the existence of a civil remedy in

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41. *ASA*, s.1(l).

42. *Sparling*, *supra* note 34.

Alberta for misrepresentation in a circular and the absence of a similar remedy in the *CBCA*. This does not change the substantive duty imposed by the provincial statute. Directors are still civilly accountable in the event of misrepresentations in a directors' circular. Accordingly, the burden imposed on directors by the provincial statutes through the use of civil sanctions is unchanged by the overlapping of the provincial and federal jurisdictions.

The *CBCR* s.68(a)(ii) requires that "... where *known* to the directors or officers ... " [emphasis added] the circular is to disclose holdings of offeree securities by persons who hold shares that carry more than 10% of the votes attached to the offeree's securities. This requirement tracks the *ASCR* Form 32, Item 4 closely. However, there is a conspicuous difference. *CBCR* s.68 speaks of "known"; *ASCR* Form 32, Item 4 requires disclosure of the information "... *if known after reasonable inquiry* ...." [emphasis added] This difference of language is repeated throughout the *CBCR* requirements. Does this result in a substantive difference in the burden placed on the directors when they are preparing the directors' circular under the *CBCA*?

Whether the difference in language results in a difference in substance will depend upon whether or not the provisions of the *CBCA* are operating alone or are operating in conjunction with the provisions of a provincial statute. If they are acting alone, it appears that the burden placed

on the directors is actually reduced. The concept of "known" implies a current state of knowledge. It does not imply the active pursuit of further information. It does not create the sense of a dynamic process as do the terms "inquiry" and "investigation." Accordingly, it is arguable the provisions of the *CBCA* governing the contents of the directors' circular do not impose a duty to make an active search for additional information. However, when the provisions of the *CBCA* are operating in conjunction with those of a provincial statutes, the burden will be dictated by the higher standard required by the provincial statutes.

In summary, the *CBCA*, as it pertains to take-over bids, lacks a civil remedy specifically aimed at misrepresentations in circulars. The penal provisions which are applicable do not require that reasonable diligence actually have been exercised. The use of the term "known" in the regulations prescribing the content of the directors' circular reduces the directors' duties to a mere review of existing information that they and the corporate officers are already aware of. It does not imply the need for the active pursuit of new, relevant information. Accordingly, where the provisions of the *CBCA* function in isolation, the burden on the target firm's directors is arguably lower than that imposed by the provincial statutes.

In circumstances where both provincial and federal regimes apply, the standard of conduct must be raised to a

level necessary to satisfy the more stringent of the regimes. In this context, the more stringent regime will be that which is established by the provincial statutes.

Contents of Directors' Circular Under the *CBCA*

The contents of the *CBCA* directors' circular are stipulated in the *CBCR* at ss.68-73. A review of these sections reveals that the directors' circular under the *CBCA* and the directors' circular under the provincial statutes are consistent with, but not identical to, one another.

As was shown in the previous section, there is a difference in the burden placed on the directors when they need only comply with the provisions of the *CBCA*. It follows that, when preparing responses to the requirements of the directors' circular under the *CBCA* for those particulars that follow the phrase "where known", the directors need only assess the information they and the officers are already aware of. They will have to seek verification where it is available, but, on a strict reading, there is no need to enter into an investigation for new data. Due to this reduced burden in the federal jurisdiction, it follows that when a take-over bid triggers the provisions of the *CBCA* and one or more of the provincial statutes, it is the burden imposed by the provincial statutes that should govern the preparation of the directors' circular.

CHAPTER SUMMARY

The analysis in this chapter advanced the goal of the thesis by providing a review of the manner in which the *CBCA* affects the duties of a target firm's directors. This discussion, when combined with the analysis of the Alberta securities regime, provides the final element in the explication of the responses that a target firm's directors must make when an uninvited take-over bid has been received.

From this point the thesis will proceed to an examination of the optional and prohibited responses in Chapter 5. That chapter will conclude the thesis with an assessment of the legal regime's fit to the financial model.

CHAPTER 5

OPTIONAL AND PROHIBITED RESPONSES

INTRODUCTION

The thesis has developed the theory of the firm, derived a prescriptive model of the firm, determined the interests that the model values, and examined the responses that are required from a target firm's board of directors upon receipt of an uninvited take-over bid. This chapter examines the responses that are optional and those that are prohibited. It will conclude the thesis by comparing the financial model of the firm to those portions of the take-over regime that have been examined in the thesis. The interests that are valued will be compared to those that are advanced and a conclusion will be drawn as to the harmony between the model and the law.

OPTIONAL RESPONSES

The optional responses available to the board of directors depend for their validity on the powers of the directors. The law that determines the limits and proper uses of those powers is the law that determines what, if any, optional responses are available to a board of directors.

There are two leading cases in Canada that must be discussed when considering the constraints on a board's

choice of optional responses to a take-over bid. They are: *Teck Corporation Limited et al.* v. *Millar, et al.*[1] and *347883 Alberta Ltd.* v. *Producers Pipelines Inc.*[2] Both are well respected and frequently cited authorities.[3] However a flaw appears in the reasoning of both cases. That flaw unnecessarily confuses the duties imposed on directors. It arises due to a failure by the courts to keep the legal status of various corporate constituents separate. The thesis will argue for a more disciplined, alternative analysis. This analysis will help directors determine an appropriate course of action. The resulting decision-making process is more consistent with general principles of corporate law, and the guidance given by the analysis is robust and appropriate. Indeed, in many cases the decisions made pursuant to the alternative analysis will be the same as that made under the currently accepted legal analysis. The alternative analysis, however, has the advantage of giving directors and their advisors a more precise means to assess their positions and conduct. This is particularly important

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1. *Teck Corporation Limited et al.* v. *Millar, et al.* (1972), [1973] 2 W.W.R. 385 (B.C.S.C.).

2. *347883 Alberta Ltd.* v. *Producers Pipelines Inc.* (1991), 3 B.L.R. (2d) 237 (Sask.C.A.).

3. *Teck, supra* note 1 has, for example, been cited in: *Howard Smith* v. *Ampol Petroleum*, [1974] A.C. 821.; *ibid., Producers'*; *Olympia & York Enterprises Ltd.* v. *Hiram Walker Resources Ltd.* (1986), 59 O.R.(2d) 254 (Div. Ct.); *820099 Ontario Inc.* v. *Harold E. Ballard Ltd.* (1991), 3 B.L.R. (2d) 113 (Ont. Div. Ct.); *First City Financial Corp. Ltd.* v. *Genstar Corp. et al.* (1981), 33 O.R. (2d) 631 (H.C.).

when considering potential, future developments in securities regulation with special regard to the role being played by securities commissions in controlling the conduct of the parties involved in take-overs.

Teck Corporation Limited

Prior to *Teck*, the Anglo-Canadian law that controlled the exercise by directors of their powers was contained in the "proper purposes" test.[4] This test involved two steps. First, the nature and purpose of the power that was invoked was determined.[5] Next, the purpose for which the power was exercised was examined.[6] If the actual use was inconsistent with the nature and purpose of the power, then it was concluded that the power was used for an improper purpose.[7] On this finding, the actions of the directors would be set aside. In *Teck*, the Court rejected this doctrine as being too restrictive for the realities of modern business.

The plaintiffs in *Teck* had complained about certain actions taken by the board of directors of Afton Mines Ltd. (N.P.L.)("Afton"). Afton's board, in the face of Teck having acquired a majority of the outstanding shares of Afton, had

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4. *Ibid.*, *Howard Smith*. *Howard Smith* has, for example, been cited in: *Producers'*, *supra* note 2; *ibid.*, *Olympia & York*; *ibid*, *Harold E. Ballard Ltd.*

5. *Ibid.*, *Howard Smith*, at 835.

6. *Ibid.*

7. *Ibid.*

issued a large number of shares to Canadian Exploration Ltd. under the terms of a development agreement. The agreement was concluded over the express objections of Teck which was, at that time, Afton's majority shareholder. The chief ground of Teck's complaint was that the Afton board was carrying out an improper purpose when it entered the contract and issued the shares.[8]

Justice Berger started his decision by stating an obvious but vitally important conclusion: Afton's board of directors had the power to manage Afton's affairs.[9] The directors had the power to issue the shares, and they had the power to enter the contract.[10] Justice Berger quoted provisions of the company's Articles in support of this conclusion. The quotation included the stipulation that no regulation made by the company at a general meeting could retroactively invalidate an act of the directors that was valid prior to the regulation being passed.[11] That is, even the shareholders as a whole could not invalidate an other-

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8. *Teck*, *supra*. note 1 at 404.

9. *Ibid.* Justice Berger cites only the provisions in the Articles of association for this proposition. In British Columbia, at this time, the situation was the same as in England. The power to manage the company resided initially in the shareholders. The shareholders delegated it to the directors through the provisions of the Articles. See: *Ibid.*, at 344. See also: *Company Act*, R.S.B.C. 1979, c.59, as amended, s. 141. *Contra.*: *Alberta Business Corporations Act*, R.S.A., 1980, c. B-15, as amended, s.97.

10. *Ibid.*, *Teck*.

11. *Ibid.*

wise valid act of the board of directors. The power of the directors to manage the affairs of the company was complete.[12] The directors were not agents of the shareholders,[13] nor could the shareholders, even by resolution at a general meeting, dictate to the directors.[14] These limits on shareholder rights applied to Teck notwithstanding that Teck was, at the vital time, the majority shareholder:

> A majority of the shareholders do not, by reason of the fact that they have a majority, acquire thereby any legal right. Their rights, like those of any other shareholder, are derived from applicable companies' legislation, the company's memorandum and articles, and the case law developed by the judges.[15]

Directors must act in what they *bona fide* consider to be the best interests of the company.[16] Justice Berger cited a variety of older English and Canadian cases as authorities that supported a specific prohibition against issuing shares for the purpose of keeping control of the corporation in the hands of the board of directors.[17] The most modern of the

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12. *Ibid.* at 405.

13. *Ibid.*

14. *Ibid.*

15. *Ibid.*

16. *Ibid.* at 406-407. Justice Berger attributes this statement of law to "... cases decided in the United Kingdom ...."

17. *Ibid.* at 407.

cases cited is *Smith, et al.* v. *Hanson Tire & Supply Co.*[18] a 1927 decision from the Saskatchewan Court of Appeal. Corporate law had undergone fundamental legislative change between the time those cases were decided and when *Teck* was being considered, and, due to those changes and changes in the general business environment, the validity of the proposition for which the cases were cited had to be called into question. The plaintiffs were not concerned that Afton's board had attempted to retain control of the company. In fact, they acknowledged that it was possible the directors considered it in the best interest of the company that Teck's majority should be defeated.[19] The plaintiffs, nonetheless, pressed their attack on the basis of *Hogg* v. *Crampthorn Ltd. et al.*[20]. Justice Berger interpreted *Hogg* to stand for the proposition that:

> ... [T]he directors have no right to exercise their power to issue shares, in order to defeat an attempt to secure control of the company, even if they consider that in doing so they are acting in the company's best interests.[21]

The plaintiffs argued that their case was on all fours with *Hogg* and, therefore, the unavoidable conclusion was that the issue of the shares was improper and ought to be

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18. *Smith, et al.* v. *Hanson Tire & Supply Co.*, [1927] 2 W.W.R. 529.

19. *Teck*, *supra* note 1 at 407.

20. *Hogg* v. *Crampthorn Ltd. et al.*, [1967] Ch. 254.

21. *Teck*, *supra* note 1 at 409.

set aside.[22] Justice Berger interrupted the Teck juggernaut by raising what he referred to as "... an issue of profound importance in company law." Specifically, he was concerned that the law required directors to act in a manner which they felt was in the *bona fide* best interest of the company. The law did not require the directors to act in what the court says is in the *bona fide* best interests of the company.[23] He pointed out that the above interpretation of *Hogg* was inconsistent with the law in *Re Smith & Fawcett Ltd.*[24]:

> How can it be said that directors have the right to consider the interests of the company, and to exercise their powers accordingly, but that there is an exception when it comes to the power to issue shares, and that in the exercise of such power the directors cannot in any circumstances issue shares to defeat an attempt to gain control of the company? It seems to me that this is what *Hogg v. Crampthorn* says. If the general rule is to be infringed here, will it not be infringed elsewhere? If the directors, even if they believe they are serving the best interests of the company, cannot issue shares to defeat an attempt to obtain control, then presumably they cannot exercise any other of their powers to defeat the claims of the majority, or, for that matter, to deprive the majority of the advantages of control. I do not think the power to issue shares can be segregated, on the basis that the rule in *Hogg v. Crampthorn* applies only in case of an allotment of shares.
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> The impropriety lies in the directors' purpose. If their purpose is not to serve the company's interest, then it is an improper purpose.[25]

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22. *Ibid.*

23. *Ibid.* at 410.

24. *Re Smith & Fawcett Ltd.*, [1942] Ch. 304.

25. *Teck, supra* note 1 at 409.

Justice Berger noted there was Canadian authority to support, and Canadian authority to reject, *Hogg*.[26] It is submitted that after this point Justice Berger drew a conclusion that is inconsistent with the modern concepts of corporate law. He stated that, in the classical theory, directors owe their duty to the company and that a company is its shareholders.[27] It may be argued that, as British Columbia has retained the English model for corporations, the old cases that tend to smudge the legal distinctions between shareholders and the corporation remain good law.[28] It is less arguable that this is good law in jurisdictions that have adopted the statutory division-of-powers model. Under the English regime, the Articles of the company formed a contract between all its members.[29] Original authority over the affairs of the company was held by the

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26. *Ibid.* at 411.

27. See: *Ibid.* at 412, where Justice Berger cites *Martin* v. *Gibson* (1907), 15 O.L.R. 623, for the proposition that "... [t]he company's shareholders are the company."

28. British Columbia has retained the articles and memorandum of association method for incorporation. They have also retained the statutory provision that deems the articles a contract between company members. However, the *Company Act* treats the three categories of parties being discussed, directors, company and shareholders, as separate entities. Each is given, as in the division of powers statutes, a package of responsibilities and rights. Neither the statute nor the model articles contain a provision that could justify identifying the company with its "shareholders as a whole." See also: B.L. Welling, *Corporate Law in Canada: The Governing Principles*, 2d ed. (Toronto: Carswell, 1991) at 61.

29. *Ibid.*, Welling, at 60.

shareholders. A portion of that power was then delegated to the directors.[30] Rooted as this law is in the traditions of the early joint stock companies and, having regard to this contractual relationship, it is understandable that some uncertainty could exist as to the legal status and responsibilities of the parties.[31] There is no such excuse within the division-of-powers model.[32] Each category of participant is granted certain privileges and is burdened with certain responsibilities. If the privileges and responsibilities are not specified by the incorporating statute, then they do not exist. The corporation has a separate legal status. The shareholders have their role to play, and the directors owe a duty to the corporation. There is no legal basis to identify the shareholders with the corporation. They are legal solitudes. The division-of-powers statutes explicitly impose a duty on the directors to conduct themselves with an eye to the best interests of the corporation. There is nothing in the statutes that imposes a duty on directors to act in the best interests of the shareholders. Accordingly, the directors do not owe a statutorily imposed fiduciary duty to the

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30. *Teck*, *supra* note 1 at 344.

31. B.R. Cheffins, *Company Law: Theory, Structure and Operation* (Oxford: Clarendon Press, 1997) at 39-41.

32. Welling, *supra* note 28 at 61.

shareholders.[33] This does not mean that the directors may run roughshod over the shareholders. It simply means that the shareholders will have to look somewhere other than to a fiduciary duty for recourse. They could, for example, use the provisions dealing with oppression remedies.[34]

Justice Berger began with the proposition that in classical theory the company is its shareholders. It appears that this proposition also represented his view on the limit of the interests that the directors could consider under the classical theory. The board of directors must act in the best interests of the corporation *qua* the shareholders as a whole. He stated, though, that classical theory must give way to the facts of modern life.[35] The ability of the directors to consider the interests of employees would not lead to a conclusion that they had not acted in the best interests of the company. A board of directors that considers the

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33. Fiduciary duties can, of course, arise from sources other than statute. There is nothing within the *ABCA* or *CBCA* that prohibits the existence of the fiduciary duty towards shareholders so long as such a duty is not in conflict with the directors' primary duty to act in the best interest of the corporation. In circumstances where a fiduciary duty in favour of the shareholders has been imposed on the directors, there is no problem in so far as the interests of the shareholders and the interests of the corporation are identical. When they diverge, the directors must satisfy the primary duty to the corporation. It is in this sense that it is stated that the directors do not owe a fiduciary duty to the shareholders.

34. See for example: *Business Corporations Act*, R.S.A. 1980, c.B-15, as amended, s.234 and *Canada Business Corporations Act*, R.S.C. 1985, c.C-44, as amended, s.241.

35. *Teck*, *supra* note 1 at 412.

effects on a decision on the community "... could not be said [to have] not considered *bona fide* the *interest of the shareholders*.[36] [emphasis added] In this statement Justice Berger has repeated the error that blurs the distinction between the shareholders and the company. Next, he drew the conclusion that the directors could have had respect for interests other than those of the company's shareholders:

> ... [I]f they observe a decent respect for other interests lying beyond those of the company's shareholders in the strict sense, that will not, in my view, leave directors open to the charge that they have failed in their fiduciary duty to the company.[37]

Regrettably, because his Lordship has confused the roles of the company and the shareholders, this otherwise sensible statement of law must be treated with care. Justice Berger took this proposition and he drew the conclusion that directors could, in appropriate situations, issue shares to prevent a party seeking a majority from obtaining it:

> My own view is that the directors ought to be allowed to consider who is seeking control and why. If they believe that there will be substantial damage to the company's interests if the company is taken over, then the exercise of their powers to defeat those seeking a majority will not necessarily be categorized as improper.[38]

And at page 414:

> I think the courts should apply the general rule in this way: The directors must act in good faith.

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36. *Ibid.*

37. *Ibid.* at 413.

38. *Ibid.*

> Then there must be reasonable grounds for their belief. If they say that they believe there will be substantial damage to the company's interests, then there must be reasonable grounds for that belief. If there are not, that will justify a finding that the directors were actuated by an improper purpose.

On its own, this statement of law is very forward looking and instructive. However, due to the earlier identification of the shareholders with the company, it loses much of its appeal. Justice Berger continued on in his decision to consider issues raised in the case that are not relevant to this thesis. Therefore, this analysis will conclude with a brief review.

Justice Berger advanced, by a considerable distance, the law regarding the actions a board of directors could take. He broke free of the *Hogg* dogma wherein a share issue was improper, regardless of its motivations, if it was done with the intention or purpose of preventing those seeking a majority from obtaining the majority. He laid the foundation for a new framework that allows directors to *bona fide* consider interests outside of those dictated by the "classical theory." To this point everything is fine. However, by adopting the older English identification of the corporation with its shareholders, he left directors serving two masters. The interests of the corporation and the interests of the shareholder are not identical. How, then, can a conscientious director satisfy both? The answer, as suggested below, is that they need not. Before dealing with that

issue, the current discussion will continue by looking at a case that develops the law in the *Teck* decision.

Producers Pipelines Inc.

In 1991 the Saskatchewan Court of Appeal considered a case that involved many of the issues that were present in *Teck*. *Producers* involved the invocation of take-over defences by the board of directors of the defendant firm. Saskatchewan Oil & Gas Corporation had decided to make a bid to acquire Producers Pipelines Inc. ("Producers"). Producers' board responded by adopting a shareholders' rights plan that completely frustrated the take-over bid. At the same time, the board launched an issuer bid. The effect of these actions was to deny the shareholders access to the take-over bid, and to force the shareholders to hold their shares in a falling market or tender them to the issuer bid. The situation thereby created had only one purpose: it was intended to entrench the board of directors. The plaintiff brought an action to have the shareholders' rights plan declared illegal, and for an order directing that the plaintiff's take-over bid could proceed. The plaintiff was unsuccessful in Chambers and pursued the matter to the Court of Appeal. Amongst the plaintiff's grounds of appeal was the allegation that the defendant's board had failed to act in

the best interests of the company as there was no good business purpose behind the issuer bid.[39]

The Court of Appeal began its analysis with a review of shareholders' rights plans in general, or as they are more commonly known, poison pills. In the course of this discussion they introduced and considered some of the provisions and purposes of the *Canadian Securities Administrators National Policy No. 38*.[40] The Court also considered the duties placed on directors by the provisions of the Saskatchewan *Securities Act*.[41] In particular, they considered the requirement that directors issue a directors' circular within 10 days of the take-over bid:[42]

> This background as to the adoption of poison pills, as created in the United States, and imported into Canada, and the policy behind the take-over bid provisions in the provincial Securities Acts in Canada is important to this case. One of the fundamental issues in this case is the extent to which the policy considerations behind the securities legislation should influence the court's interpretation of (a) the powers of directors to act, in respect of actual or apprehended take-over bids, with or without the approval of shareholders (b) the duties of the directors to act in the best interests of the corporation, *including the shareholders*, and (c) the right of shareholders to decide the disposition of their shares and the terms of disposition.[43] [emphasis added]

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39. *Producers'*, *supra* note 2 at 249.

40. *Ibid.* at 252.

41. *Securities Act*, 1988, S.S. 1988-89, c.S-42.2.

42. *Producers'*, *supra* note 2 at 254.

43. *Ibid.* at 255.

The Saskatchewan *Business Corporations Act*[44] ("*SBCA*"), is a division-of-powers statute. The *SBCA* specifies the duties and powers of each of the constituencies that go into the organization, operation, and ownership of a corporation. There is no reason, therefore, for the inclusion of a duty on the part of the directors to act in the best interests of the shareholders. Section 97(1) of the *SBCA* provides:

> Subject to any unanimous shareholders' agreement, the directors of a corporation shall:
> (a) exercise the powers of the corporation directly or indirectly through the employees and agents of the corporation; and
> (b) direct the management of the business and affairs of the corporation.

Section 117(1):

> Every director and officer of a corporation in exercising his powers and discharging his duties shall:
> (a) act honestly and in good faith with a view to the best interests of the corporation; and
> (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

As Justice Berger did in *Teck*, the Court of Appeal in *Producers'* relied on old English and Canadian cases as authority for the proposition that directors must act in the best interests of the corporation and all of its shareholders.[45] They cite the 1907 case of *Martin* v. *Gibson*[46] from the Ontario Court of Appeal and the 1950 English case

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44. *Business Corporations Act*, R.S.S. 1978, c.B-10, as amended.

45. *Producers'*, *supra* note 2 at 256.

46. *Martin* v. *Gibson* (1907), 15 O.L.R. 623.

of *Greenhalgh* v. *Ardene Cinemas*[47] in support of this proposition. These cases were, no doubt, strong authority within the legal environment in which they were argued. However, to transplant this principle across decades and into an entirely different regime is, arguably, an error. It is the same error as that made by Justice Berger in *Teck*.

The Saskatchewan Court of Appeal considered *Teck*. The Court accepted, in part, Justice Berger's reasoning but leaned more towards the decision of the Nova Scotia Court in *Exco Corp* v. *Nova Scotia Savings & Loans Co.*,[48] agreeing, as they did with the Nova Scotia Court, that *Teck* could have been decided on narrower grounds. They also considered *Olympia & York Enterprises Ltd.* v. *Hiram Walker Resources Ltd.*[49]. In a quotation from *Hiram Walker* included in their judgement, the Saskatchewan Court of Appeal repeated the now familiar concern about a "duty to shareholders."[50]

The Saskatchewan Court of Appeal expressed the opinion that the Canadian law developed in *Teck* and *Exco* was not inconsistent with the American law known as the "business

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47. *Greenhalgh* v. *Ardene Cinemas*, [1950] 2 All E.R. 1120 (C.A.).

48. *Exco Corp* v. *Nova Scotia Savings & Loans Co.* (1987), 35 B.L.R. 149 (S.C.T.D.).

49. *Olympia & York Enterprises*, *supra* note 3.

50. *Producers'*, *supra* note 2 at 210:
> ... What options did the directors have? If they did nothing, *it would be a breach of duty to shareholders*. [emphasis added]

judgement rule." And, presumably due to the genesis of poison pills in the United States, the Court considered and eventually adopted this rule into Canadian law. The business judgement rule, as developed and applied in the United States, recognizes that:

> In a take-over situation, the directors will often be in a conflict of interest situation, and, in implementing a poison pill defence strategy, the directors must be able to establish that (a) in good faith they perceived a threat to the corporation, (b) they acted after proper investigation, and (c) the means adopted to oppose the take-over were reasonable in relationship to the threat posed.[51]

The Saskatchewan Court of Appeal concluded that while the *Teck* and *Exco* tests do not conflict with the American rule, the three tests were not yet enough for them to judge the appropriateness of the directors' actions and thereby to determine the outcome of the case. The Court continued its analysis by looking at *National Policy No. 38*, considering it to be an accurate reflection of the policy considerations that underlie the legislation:

> Just as the provisions were intended to prevent abusive, coercive or unfair tactics by persons making take-over bids, they were equally intended to limit the powers of directors to use defensive tactics which unnecessarily deprive the shareholders of the right to decide to whom and at what price they will sell their shares. Section 108 of the *Securities Act*, 1988, indicates that the primary role of the directors in respect of a take-over bid is to advise the shareholders, rather than to decide the issue for them. As noted in the policy statement, the primary objective of the legislation is to protect the *bona fide* interests

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51. *Ibid.* at 260.

> of the shareholders of the target company and to permit take-over bids to proceed in an open and even-handed environment. Unrestricted auctions produce the most desirable results in take-over bids.[52]

The Court concluded that:

> If, after investigation, they determine that action is necessary to advance the best interests of the company, they may act, but the onus will be on them to show that their acts were reasonable in relation to the threat posed and were directed to the benefit of the corporation and *its shareholders as a whole*, and not for an improper purpose such as entrenchment of the directors.[53] [emphasis added]

The Court here, as Justice Berger did in *Teck*, brought the shareholders as a whole under a protective umbrella by including their interests in the definition of the interests of the corporation. As argued above, this is not an appropriate analysis. While protecting the rights of the shareholders to sell or not sell in accordance with a take-over bid or otherwise is a worthy endeavour, it need not be accomplished at the expense of the discrete natures of the shareholders and the corporation.

What is added to this otherwise admirable decision by confusing the identities of the shareholders and the corporation? Nothing that cannot be dealt with through another form of analysis that pays closer attention to the legal independence of the corporation and the proper roles of corporate and securities law. It can be argued that the

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52. *Ibid.*

53. *Ibid.* at 261.

interests of all concerned can be protected by a proposition of law that builds on *Teck* and *Producers'*, but does not rely on the identification of the shareholders with the company. Rather, it uses the considerable machinery given to the securities regime to protect the interests of shareholders in the context of a take-over bid.

An Alternative Analysis

If all the references regarding fiduciary duties owed by directors to shareholders are removed from the statements of law enunciated in *Teck* or in *Producers'*, directors are left with a single duty imposed by the incorporating statutes. This is the duty to act *bona fide* in the best interests of the corporation, that is, the corporation as a legal entity distinct from its shareholders. What then of the shareholders?

The shareholders have a claim to certain rights. They have a right to the information as provided for in the securities regimes. They have the right to sell their shares as and how they wish. These are rights whose protection resides properly within the securities regimes and not within the general body of corporate law. The securities regimes make it clear that, as a matter of policy and law, shareholders are to have access to take-over bids without undue interference from the target firm's board of directors. Shareholders should not look to the target firm's board of directors for protection of this right except in so

far as those rights are consistent with the best interests of the corporation.

Who will protect the shareholders? The securities commissions and the securities legislation will protect the shareholders. The goal of the corporations statutes is to have appropriate individuals acting as directors and officers of corporations. These individuals are to conduct themselves so as to serve the best interests of the corporation. The goal of the securities regimes is the protection of the investing public. Included in this, as *National Policy No. 38* makes clear, is the policy that target firm shareholders are to have access to the information they need to make an informed decision about whether or not to tender to the take-over bid. And the securities regimes will work to see that shareholders will, as a matter of right, be able to tender to that bid without undue interference from the target firm's board of directors. Toward this end the securities acts and regulations require take-over bid circulars and directors' circulars to be provided to offeree shareholders. The securities commissions oversee the content of these documents and the conduct of the parties involved in the take-over. If the circulars fail to disclose as they are required to, complaints can be raised through the procedures in place at the various commissions. If the target firm's board of directors has performed as required in preparing the circular, but they then unduly obstruct the

take-over bid through the use of inappropriate defensive tactics, the matter may also be pursued through the relevant securities commissions.

The securities commissions have the expertise and the tools to secure these goals on behalf of the shareholders. The board of directors can, on the reasoning of *Teck*, take the interests of the shareholders into consideration. But to identify the interests of the shareholders with the interests of the corporation is to ignore the legal concepts involved in a corporation. It is far better to keep the identities discrete and rely on the securities regime to protect the interests of the shareholders.

Re Canadian Jorex Limited and Mannville Oil & Gas Ltd.,[54] a decision of the Ontario Securities Commission Board, is an example of how the securities regime can be used to keep a take-over bid functioning properly. Mannville decided to make a bid for control of Jorex. Jorex's directors recommended rejection of the bid in their directors' circular, and they adopted a poison pill. It appeared that their intention was to buy enough time to seek out a competing bid in the take-over. Another bidder was found. The Jorex board waived the new bid through the poison pill, but they refused to do the same for the Mannville bid. Mannville

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54. *Re Canadian Jorex Limited and Mannville Oil & Gas Ltd.*(1992),4 B.L.R.(2d) 2 (O.S.C.B.).

asked the Securities Commission Board to terminate the poison pill:

> [T]he central issue is not whether the board of directors of a target company acted in good faith in adopting a poison pill or, indeed, any other defensive tactic (as might be the case were the matter before the courts), but rather *where the public interest, in the broadest sense, lies.*[55] [emphasis added]

The Securities Commission Board did not become involved in a dubious analysis about fiduciary duties of directors toward shareholders. They concentrated on their proper jurisdiction: concerns about the public interest:

> [T]he only question we really had to decide was whether the rights plan had served its purpose in facilitating an auction for Jorex, and so ought to be discontinued ....[56]

The Board stated that in its view the public interest, in such cases as Jorex, is reflected in *National Policy No. 38*. The Commission's primary concern is not whether the board of directors should have done what they did but:

> ... [W]hether those tactics 'are likely to deny or severely limit the ability of the shareholders to respond to a take-over bid or a competing bid' ... or 'may have the effect of denying to shareholders the ability to make a [fully informed] decision and of frustrating an open take-over process.'
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> For us the public interest lies in allowing shareholders of a target company to exercise one of the fundamental rights of share ownership - the ability to dispose of shares as one wishes - without undue hinderance from, among other things, defensive tactics that may have been adopted by the target board with the best intentions, but that

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55. *Ibid.* at 4.

56. *Ibid.* at 5.

> are either misguided from the outset, or, as here, have outlived their usefulness.[57]

There are, then, two separate regimes at work in this analysis. First there is the corporate regime, which is concerned with the ongoing relationships of the corporation, its shareholders, its directors, and its claimholders. Each constituency has its own set of rights and duties. Then there is the securities regime, which imposes duties of disclosure on the target firm's board of directors and provides a machinery for testing and, if necessary, for removing, poison pills and other defensive tactics. Denying the existence of a fiduciary duty owed to the shareholders by the directors does not leave the shareholder without remedy. They still have full recourse to the shareholders' remedies in the corporate statutes, and, as just shown, they have the protection of the securities regime. This alternative analysis does, however, keep legally distinct concepts separate, and it provides a more disciplined analysis.

THE AVAILABLE, OPTIONAL RESPONSES

After they have fulfilled the duties imposed by the relevant securities acts, the target firm's board of directors will consider their next step. The directors may choose to do nothing more; they may choose to actively promote the take-over bid; or they may choose to actively resist the take-over bid. Regardless of the alternative adopted, the

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57. *Ibid.* at 6-7.

board of directors must make their decision on the basis of their duty to the corporation. Applying the Canadian business judgement rule from *Producers'*, they must: (a) make an investigation; (b) determine, *bona fide*, where the best interests of the corporation lie; and (c) initiate a course of action that is reasonable in relation to the threat posed. If they act, or decide not to act, on the basis of this test, their actions will satisfy the business judgement rule.

Most commentary and litigation regarding the responses of a target firm's board of directors involves a third alternative. This is alternative of active resistance.

Active Resistance

When the board has decided on a course of active resistance they have, in effect, decided to mount a take-over defence or take-over defences. The structures of the defences adopted by various boards of directors is legion. Notwithstanding this, the defences fall into relatively few categories.[58] A take-over defence may be general in application, that is, it is not aimed or directed at a specific acquiror. Rather, it is set up to make the firm less attractive to all potential acquirors. Examples include staggered boards of directors or dual class share struc-

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58. There has been a great deal written about take-over defences. The thesis will discuss the defences only to the extent required to place them within its context and to provide illustrations of the application of the law.

tures. A take-over defence may also be specific. The defence selected is intended to prevent a particular acquiror from obtaining control of the firm. Examples include poison pills, instituted when the acquiror's intentions were made known, and litigation. Many of the defences that are popular today can be used for both general or specific defences. For example, a poison pill may be introduced without regard to any specific take-over bid and thereby be considered a general deterrent. On the other hand, if it is introduced in response to a specific take-over bid (such as in the *Producers'* case) it is a specific defence.

Some take-over defences are found in the corporation's constitution. This category of defence includes dual class share structures, staggered boards of directors, and extra-ordinary majority requirements. These will, more often than not, be defences of general application. A list of similar defences assembled with reference to American corporations would be considerably longer. In the United States such a list would include defences such as fair price provisions, limitations on shareholders' rights to requisition meetings, and related super-majority provisions.[59] These defences either are not allowed under Canadian laws, or they are

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59. T.W. Little, *A comparative analysis of the legal status of hostile take-over defence mechanisms in the United Kingdom, Canada and the United States of America* (LL.M. Thesis, University of Alberta, 1996) at 8-11.

unnecessary due to the take-over bid regulations that are in place in Canada.

Take-over defences may also be established by directors' resolutions which must then be ratified by the shareholders. The sale or optioning of the corporation's prime assets, and amalgamation are examples of this category of defence. There are, as well, take-over defences that can be initiated by the board of directors that do not require ratification or support from the shareholders. Changes in dividend policy, golden parachutes, vesting of pension fund over-contributions, commencement of litigation and regulatory complaints, and defensive acquisitions are in this category.

The Take-over Defences

The legal basis on which take-over defences are established must be found in the incorporating statutes of the relevant jurisdiction. Some of the defences, their characteristics, and the relevant statutory provisions are summarized below.

Shareholders' Rights Plans

Shareholders' rights plans are also known as poison pills. In this thesis these terms have been and will continue to be used interchangeably. The goal of these plans is to make the acquisition of control of the target firm prohibitively expensive. The essential element of the plan is a

rights issue which is distributed to the shareholders as a dividend. These rights carry no vote, trade with the common shares, and are of no real value when issued because their exercise (or "strike") price is very high in relation to the current market price of the shares. The rights are also redeemable by the board of directors for a nominal amount before the poison pill provision is triggered. However, in the event an acquiror accumulates more than a specified percentage of shares, the rights become exercisable at a substantial discount; all the rights, that is, except those attached to the shares of the acquiror. The plans generally provide for permitted bids, and they often provide for a waiver by the board of directors of all or part of the plan's provisions in regard to a specific bid.[60] The overall effect is that an acquiror must either make a permitted bid (the requirements for a permitted bid are usually sufficiently onerous that no one would make one), negotiate a waiver of the plan with the board of directors, or be ready to spend a great deal of money buying up the flood of shares issued pursuant to the rights. It is the second option, negotiation, which is generally used to resolve the conflict.

Two reasons have been suggested to justify implementation of these plans. First is that the plan, by forcing the

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60. *Producers'*, *supra*. note 2 at 249. See also: J.G.MacIntosh, "The Poison Pill; A Noxious Nostrum for Canadian Shareholder" (1988-89), 15 Can.Bus.L.J. 276.

acquiror to deal with the board or by forcing the acquiror to use a longer bid period,[61] allows the board to either negotiate a better deal for the target firm's shareholders or to start an auction by finding another interested bidder. This justification is consistent with the public interest policy enunciated by the securities commissions, but it does not directly address the directors' primary duty of acting in the best interests of the corporation.

The second reason suggested for the implementation of a shareholders' rights plan is that management does not want to be displaced. Displacement of management is a fairly common occurrence in a take-over. Accordingly, getting the acquiror to the negotiating table is very important in ensuring that management is properly provided for in the take-over. Or, in the alternative, the plan will stop the take-over completely, leaving management in their place. This is not consistent with the public interest policy of the securities commissions, and, for the most part, it is not likely to be in the best interests of the corporation.

The board must have certain powers over the affairs of the corporation before they can establish a shareholders' rights plan defence. They must have the power to declare dividends in kind, issue rights, issue shares, and set the consideration for which the shares issued on conversion of

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61. This is a very common requirement for a permitted bid.

the rights will be issued. In Alberta, and under the *CBCA*, directors have the power to issue rights, and to issue shares when and for such consideration they choose, so long as to do so is not prohibited by the memorandum and articles, a unanimous shareholders' agreement, or the corporate by-laws and where statutory pre-emptive rights do not apply.[62] The power to declare dividends, in whatever form and for whatever amount, is vested in the directors as a component of the power to manage the affairs of the corporation. So long as these powers are being exercised in the *bona fide* best interests of the corporation the directors may use them. Shareholders may attack the exercise of these powers through the remedies provided for in the statutes if they believe the powers were not exercised *bona fide* in the best interests of the corporation.

Issuer Bid

Issuer bids are also known as self-tender. In Canada, corporations can buy their own shares, but they are not allowed to hold their own shares.[63] Any shares purchased in an issuer bid are cancelled or restored to the status of authorized, unissued shares.[64] In the United States corporations can hold their own shares. As a result, this defence

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62. *ABCA*, s.25; *BCCA*, s.41(6); *CBCA*, s.25; *OBCA*, s.23.

63. *ABCA*, s.30(1)(a).

64. *ABCA*, s.37(6).

is not as effective in Canada as it is in the United States where its use places a large number of shares under the control of management. An issuer bid in Canada will either increase the target's debt load and, thereby, make it less attractive; or the bid will use up excess cash, which may have been a major inducement for the take-over bid in the first place. Either way, the target is less attractive.

White Knight

The white knight defence involves the introduction of a friendly party, by the management or board of the target firm, as a competing acquiror. Management often seeks these parties out and extends preferential treatment to them. For example, they may be waived through the provisions of the poison pill, or they may get access to information that the hostile bidder does not have access to. There may even be a breakup fee which provides for the target to pay a large sum to the white knight in the event the white knight is not successful in acquiring control of the target. The power to initiate this defence is found in the general power to manage the affairs of the corporation.

Amalgamation

Amalgamation is a variation on the white knight defence. Instead of favouring the friendly corporation in the take-over process, a deal is negotiated that would see the knight and the target enter into a voluntary amalga-

mation.[65] Although the directors have the authority to start the amalgamation process, the final agreement must be submitted for approval by meetings of the shareholders of the corporations involved.[66] The agreement must be passed by a special resolution.[67]

Defensive Acquisitions

A defensive acquisition is intended to make the target an unacceptable purchase by creating regulatory hurdles for the acquiror. For example, the target, not previously involved in broadcasting, may purchase an interest in a television broadcaster and thereby force the hostile acquiror to go through a regulatory process that they had not previously been subjected to. Another purpose of the acquisition may be to make the target sufficiently less valuable, hoping that the acquiror will decide to forego the acquisition. For example, a firm may purchase shares in a firm that is in financial difficulty. The power to undertake this defence is found in the general power to manage the affairs of the corporation.[68]

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65. *ABCA*, s.176.

66. *ABCA*, s.177(1).

67. *ABCA*, s.177(5); s.1(1):
"special resolution" means a resolution passed by a majority of not less than 2/3 of the votes cast ....

68. *ABCA*, s.97(1).

Changes in Dividend Policy

Announcing a special dividend increases the market price of shares until it is paid. This defence has two effects: first, it increases the price the acquiror will have to pay for the target firm; second, it will reduce the target's excess cash thereby making the target a less desirable acquisition. Directors can initiate this defence under the general power to manage the affairs of the corporation.

No Active Response

The statutes under which companies are incorporated require the directors to act "... honestly and in good faith with a view to the best interests of the corporation ...".[69] When performing this duty they must "... exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances."[70] These provisions leave the directors free to conclude, so long as they do so *bona fide*, that a take-over bid is in the best interests of the corporation. As a result, they may choose to do nothing beyond performing the steps they are required to take by the securities regimes. Under the corporate law regime the directors will be blameless.

Or will they? As previously noted, there is judicial authority for the proposition that directors owe a fiduciary

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69. *ABCA*, s.117(1)(a).

70. *ABCA*, s.117(1)(b).

duty to the corporation's shareholders. In particular, *Re Olympia & York Enterprises Ltd. and Hiram Walker Resources Ltd.*[71] suggests that there is a specific duty to maximize shareholder value.[72] This position is not consistent with the analysis presented above where it was argued that the directors owe a duty to the corporation alone. It was suggested that the shareholders are adequately protected by the securities regimes from excessive interference by the target firm's board of directors. Is there any protection for shareholders in the event the directors do not resist the take-over when there is a chance that a defence would initiate an auction to the benefit of the shareholders? If the proposition in *Hiram Walker* is the law, then there is a duty on the directors to maximize shareholder value, notwithstanding the argument in this thesis to the contrary. And there will, therefore, be a positive duty on the directors to resist the take-over. Even if this duty is little more than a result of the judicial habit of equating shareholders to corporations, a board of directors that is considering a passive role would ignore this authority at their risk. This is particularly so as the securities commissions do not seem to have specific authority to require that a take-over defence be initiated. The securities commissions' power have a wide breadth and could, in such a case, be mobilized in

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71. *Olympia & York*, *supra* note 3.

72. *Ibid.* at 279.

the public interest, but there is no specific mandate to compel a defence.

Where the board of directors is considering a passive stance, conservative counsel would recommend treating this authority as an exception to the proposition that under the modern corporate statutes the directors do not owe a fiduciary duty to the shareholders. If they are considering a passive role, the directors would be well advised to investigate the possibility of finding another bidder that is equally, or more, acceptable to the board than the present acquiror. If conducting a defence will encourage another bidder to enter the scene, the board must consider doing so. All of this is subject to the constraints of reasonableness and prudence. It follows that, if after a reasonable investigation, there are no alternative bidders, the board would be justified in assuming a passive stance. If there were a bidder that required a reasonable amount of prompting then they should provide that prompting. The board may also adopt the oil field's practice of opening a data room to any interested bidder, subject to controls over the use of the data that is thereby disclosed.

Where there is an actual conflict between the best interests of the corporation and shareholder value maximization it is the thrust of this thesis that the board of directors has only one course of action available. They must

conduct themselves so as to serve the best interests of the corporation.

PROHIBITED RESPONSES

Some time has been spent considering what a board of directors must do and what they can do, if they wish, in the context of responding to an uninvited take-over bid. The final category of responses to be considered are those that directors are prohibited from taking.

Many of the prohibited responses are simply the inverse of the required responses. For example, the board must issue the directors' circular or face a potential charge under the securities statutes for failing to comply with the requirements of the Act.[73] This sub-category of prohibited responses is self-evident from the analysis presented earlier. It is not necessary, therefore, to conduct a further review of these responses.

Other prohibited responses arise within the context of the optional responses just discussed.

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73. *ASA*, s.161(1):
Any person or company that does one or more of the following commits an offence

...

(e) contravenes the following provisions of the Act:

...

Part 13;

National Policy #38

The Securities Commissions across Canada issue National Policies which inform the members of the securities industry how the commissions will exercise certain of their powers. The National Policies are interpretive only, and they do not have the force of law.[74] They are, in effect, joint statements agreed to by the provincial securities commissions, and they are an attempt to coordinate the efforts of the commissions on matters that tend to involve more than one jurisdiction.[75] Corporations and their advisors ignore these statements at their peril.

National Policy #38 ("Policy") is entitled "Take-Over Bids - Defensive Tactics", and, as the title indicates, it presents the expectations of the commissions on the use of take-over defences and the possible consequences of a failure to live up to those expectations. The Policy recognizes that within the context of a take-over bid, the interests of the management of the target firm may differ from the interests of the shareholders:[76]

> The primary objective of take-over bid legislation is the protection of the *bona fide* interests of the shareholders of the target company. A secondary objective is to provide a regulatory framework within which take-over bids may proceed in an open

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74. *Ainsley Financial Corp. et al.* v. *O.S.C.* (1994), 18 O.S.C.B. 43 (Ont.C.A.).

75. M.R. Gillen, *Securities Regulation in Canada* (Scarborough, Ont.: Carswell, 1992) at 74.

76. National Policy #38, paragraph 1.

> and even-handed environment. The rules should favour neither the offeror nor the management of the target company, but should leave the shareholders of the offeree company free to make a fully informed decision. The administrators are concerned that certain measures taken by management may have the effect of denying to shareholders the ability to make such a decision and of frustrating an open take-over bid process.[77]

The Policy does not lay out a code of conduct for target firm directors.[78] However, directors and their advisors are warned that the commissions are prepared to examine take-over defences and other tactics used by target firms in specific cases to "... determine if they are abusive of shareholders' rights."[79]

> Without limiting the foregoing, defensive tactics that may come under scrutiny if undertaken during the course of a bid, or immediately prior to a bid if the board of directors has reason to believe that an offer might be imminent, include:
> (i) the issuance, or the granting of an option on, or the purchase of, securities representing a significant percentage of the outstanding securities of the target company;
> (ii) the sale or acquisition, or granting of an option on, or agreeing to sell or acquire, assets of a material amount; and
> (iii) entering into a contract other than in the normal course of business or taking corporate action other than in the normal course of business.[80]

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77. *Ibid.* paragraph 2.

78. *Ibid.* paragraph 3.

79. *Ibid.*

80. *Ibid.* at paragraph 4.

The commissions conclude that unrestricted auctions produce the best results, for shareholders, in a take-over.[81] The commissions advise that they will take action when they find take-over defences that are likely to result in shareholders being prevented from responding to a take-over bid.[82] It is only when the take-over defences are "... likely to deny or severely limit the ability of the shareholders to respond to a take-over bid or a competing bid ..."[83] that the commissions may take action.

The Policy does not specify the sanctions that may be used, however, cease trading orders will likely be the most frequently utilized order.[84] It is no coincidence that the matters listed in the Policy as matters that will be of concern to the commissions closely mirror the optional responses that were dealt with in the previous section. The target firm's board of directors must not set up take-over defences that "... are likely to deny or severely limit the ability of shareholders to respond to a take-over bid ...."[85] If the directors do set up such a defence, the relevant commission or commissions may, on their own initiative or in response to a complaint, conduct an inquiry into

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81. *Ibid.* paragraph 5.

82. *Ibid.*

83. *Ibid.* paragraph 6.

84. See for example: *Canadian Jorex, supra* note 54.

85. National Policy #38, paragraph 6.

the defences.[86] The Ontario Securities Commission has stated in no uncertain terms that National Policy #38 reflects its view of the public interest in take-over bids:

> For us, the public interest lies in allowing shareholders of the target company to exercise one of the fundamental rights of share ownership - the ability to dispose of shares as one wishes - without undue hinderance from ... defensive tactics that may have been adopted by the target board with the best of intentions, but are either misguided from the outset or, as here, have outlived their usefulness.[87]

Poison pills and other defences are, therefore, open to attack on two bases: they can be attacked on the grounds that they were implemented for an improper purpose; or they may be attacked because they interfere with the take-over process. A board of directors is constrained from breaching either of these prohibitions.

Insider Trading

Part 10 of the *ABCA* governs insider trading in securities of *ABCA* corporations.[88] Insider trading is, on pain of having to reimburse all gains, prohibited. For example, *ABCA*, s.125(1):

> An insider who sells to or purchases from a shareholder of the corporation or any of its affiliates a security of the corporation or any of its affiliates and in connection with such sale or purchase makes use of any specific confidential

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86. *Ibid.* at paragraph 3.

87. *Canadian Jorex*, *supra* note 54 at 7.

88. *ABCA*, ss.171, 172; *BCCA*, s.68; *CBCA*, Part XI; *OBCA*, ss.134, 135; *BCCA*, s.153; *CBCA*, Part XI; *OBCA*, s.138.

> information for his own benefit or advantage that, if generally known, might reasonably be expected to affect materially the value of the security
> (a) is liable to compensate any person for any direct loss suffered by that person as a result of the transaction, unless the information was known or in the exercise of reasonable diligence should have been known to that person at the time of the transaction, and
> (b) is accountable to the corporation for any direct benefit or advantage received or receivable by the insider as a result of the transaction.

This section is typical of those governing insider trading. "Insider" is a defined term under *ABCA*, s.121(a) which is exhaustive in its detail.

The securities acts are unanimous in their prohibition of insider trading. However, they use a different means to control this activity. The securities acts speak of trading on the basis of a material fact or material change that has not been disclosed. *ASA*, s.171(1):

> Every person or company in a special relationship with a reporting issuer that
> (a) purchases or sells securities of the reporting issuer, and
> (b) has knowledge of a material fact or material change in respect of the reporting issuer that has not been generally disclosed
> is liable to compensate the seller or purchaser of the securities, as the case may be, for damages as a result of the trade.

As with the definition of insider, the term "special relationship" is exhaustively defined.[89]

Under the incorporating statutes and the securities statutes, the directors of a target firm are insiders[90] and

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89. See for example: *ASA*, s.171(5).

90. *ABCA*, s.121(b)(ii).

persons in a special relationship[91] with the target. Directors of the target firm must not be involved in insider trading or trading on undisclosed material facts or material changes. This prohibition extends to tipping friends or associates[92] as well as the actual trading.

Laws of General Application

The laws of general application of the province and country apply to the conduct of the directors. Therefore, it should go without saying that criminal acts and sundry violations of securities and other statutes always were, and continue to be, prohibited conduct on the part of directors.

INTERESTS ADVANCED BY THE LEGAL REGIME

The Financial Model

In Chapter 2 the interests valued by the financial model of the firm were determined.[93] Those interests arise from two general concerns. First is the concern that the capital markets should function in an appropriate manner. Second is the concern that security holders should be able to rely on the market for corporate control to monitor the behaviour of those who manage the corporations in which the security holders have invested their funds. Shareholders

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91. *ASA*, ss.1(i) & 171(5).

92. *ABCA*, ss.121(b)(vi) & (vii); *ASA*, ss.171(3) & (5)(b).

93. *Supra* Chapter 2, and accompanying text.

should be able to rely on the market for corporate control to initiate and conclude take-overs when it is appropriate to do so. From this, it was determined that the financial model prizes the interests of shareholders. Specifically, the model values the shareholders' interests in the characteristics of liquidity and alienability of their investments. The model also values the shareholders' interest in the thorough and efficient dissemination of information about corporations and their operations. This process of information dissemination not only aids in the appropriate operation of the market's resource allocation function, it also facilitates the operation of the market for corporate control. The financial model resists entrenched management groups. It, therefore, values non-entrenched management. The theory of the firm makes it clear that these are matters of importance, not only at the level of aggregated decision making, but also for the decision making processes of individual investors.

How well does the legal regime respond by advancing the interests valued by the financial model?

The Legal Regime

Information Flow

The legal regime controls the take-over process through a number of devices. One such device is the requirement that the target firm's board of directors make certain, prescribed responses when an uninvited take-over bid is

received. These provisions were reviewed at length.[94] The principal requirement is that of disclosure.

The target firm's board of directors is compelled to ensure that the offeree shareholders have the information they require to make informed decisions as to whether or not to tender to the take-over bid. In the language of transaction cost economics, these provisions are designed to ameliorate information impactedness. That is, management has better access to information about the firm than do the shareholders. There is a possibility that, either through neglect or strategic behaviour on the part of management, this asymmetric distribution will continue during the term of a take-over bid to the detriment of the shareholders. Accordingly, disclosure is mandated.

The mandate requires publication and distribution of corporate information and personal information about those who are making the disclosure. The mandate also requires the directors to advise the shareholders of any steps that have been taken, or that are being taken, to resist the take-over. In this, the regulatory scheme endeavours to assist the shareholders in the interpretation of the information they receive and in anticipating events to come. The shareholders can determine the weight they will give to the information and advice contained in the disclosure. The shareholders can conclude, for themselves, if the board is

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94. *Supra*, Chapters 3 and 4 and accompanying text.

acting in the best interests of the shareholders or, perhaps, in the best interests of some other group.

The regulatory scheme insists that shareholders be informed of the facts, and it insists that the shareholders be placed in a position to assess the reliability of the information and advice they have received. These disclosure provisions not only advance the interests of the shareholders in an efficient and thorough information flow, they also enhance the interests of the capital markets in the flow of information. To this point, the interests the financial model values and the interests the legal regime advances are in close accord.

Liquidity and Alienability

The financial model of the firm values the attributes of liquidity and alienability of investments. The relationship between a modern corporation and its shareholders is premised on passive ownership.[95] The shareholder has little control over the operations of the corporation and has no responsibility for the use the corporation makes of its assets. The shareholders' interest is a financial one. Their investments have value only to the extent that they can be sold in a market that determines the investment's value. It is, therefore, in the shareholders' interests to maintain

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95. *Supra* Chapter 2 and accompanying text.

the attributes of liquidity and alienability even during the most tumultuous phases of a take-over.

The legal regime is not as assiduous in advancing the interests of liquidity and alienability as it is in supporting a thorough and efficient flow of information. In this regard, attention should be paid to the responses that the law allows the target firm's board of directors to make. That is, regard should be given to the optional responses and, in particular, the take-over defences that are allowed. *National Policy No.38*[96] sums up the situation very well. While there may be circumstances where a take-over defence enhances shareholder value (although the empirical evidence from the United States does not support this suggestion[97]), the use of take-over defences will not be tolerated where they frustrate or defeat the take-over process. The regulatory regime acknowledges that adverse effects on the interests of liquidity and alienability occur due to the use of take-over defences, but it, at the same time, tolerates these defences. To the extent the regime allows take-over defences that result in a reduction of shareholder wealth, and to the extent that those defences impair the functioning of the capital market's resource allocation function, and to the extent that those defences impair the attributes of

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96. *National Policy No.38 Take-over Bids - Defensive Tactics*.

97. MacIntosh, supra, note 60 and accompanying text.

liquidity and alienability of the shareholders' investments, the legal regime does not advance the interests valued by the financial model.

Management Entrenchment

In the analysis of the law that governs take-over defences, two alternative hypotheses were advanced to explain the use of take-over defences: the shareholders' interest hypothesis and the management entrenchment hypothesis.[98] Generally, empirical studies do not support the shareholders' interest hypothesis, and this leads to the conclusion that managerial entrenchment is the primary goal of take-over defences. The financial model of the firm is opposed to managerial entrenchment.

Managerial entrenchment impairs the market for corporate control and, thereby, inhibits the proper allocation of resources in the capital market at large. The legal regime is tolerant of take-over defences that are declared to be established for the enhancement of shareholder value. The regime is, however, ill-equipped to distinguish between take-over defences that are being conducted out of a legitimate concern for shareholder value and those that are being conducted for the dominant purpose of managerial entrenchment. As observed earlier in this chapter, the law looks to the actions of the board of directors and determines if

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98. *Ibid.*

those actions satisfy certain criteria. If so, the action is considered legitimate. The courts will invalidate defences if they do not survive the test of legitimacy. It was argued that the current legal analysis is inconsistent with corporate law of general application. And the existing analysis ought to be replaced by one that is more in accord with the legal principles underlying corporate law.

It is suggested that the directors' corporate law fiduciary duty to the corporation should not be diluted by the imposition of a fiduciary duty to the shareholders. The shareholders' interests should be left in the hands of the securities regime. The board should protect the interests of the corporation and not be governed by concerns for shareholder value. By necessary implication, the most controversial, and ultimately, the most disruptive defences, poison pills, would not be tolerated as there is no basis for their use as a means to protect the interests of the corporation. Nor, due to a lack of the requisite powers, is there any means by which such a defence could be conducted by the shareholders *per se*. The board would advance legitimate corporate interests. The interests of the shareholders would be protected by the securities regime, which could, for example, require that the bid period be lengthened and thereby encourage an auction. Positions taken by the board to protect corporate interests are subject to an explicit power held by the securities commissions to override those

positions when, in the opinion of the commission, they were adversely affecting shareholder rights. The interests the board is required to protect are thereby clearly delineated. The interests of the shareholders are clearly, and specifically, under the protection of the securities regime. The capital market is protected through the prohibition of defences that adversely affect liquidity, alienability, and the market for corporate control. Further, the mechanisms that protect the interests of the corporation's constituents found in the financial and economic environment in which the firm exists will not be subjected to disruptive intervention by overly solicitous courts.

It follows, from this discussion, that the legal regime, as currently constituted, does not advance the interest of non-entrenchment of management which is valued by the financial model.

CONCLUSION

The thesis began with a discussion of its purpose and motivation. Chapter 2 provided a discussion of the theory of the firm and derived a model of the firm. The interests the model prizes were determined, and the legal model of the corporation was introduced. That chapter provided the very important prescriptive model against which the legal regime would be compared. The ultimate purpose of that comparison was to gauge the fit between the financial model and the legal regime. Chapters 3 and 4 reviewed the first segment of

the legal regime the thesis was to analyze. They dealt extensively with the responses that the board of directors is required to make upon receipt of an uninvited take-over bid. This chapter added to the review by dealing with the optional and prohibited responses. This analysis completed the substantive review of the law and brought the thesis to its final step, that is, a comparison of the interests valued by the financial model and those actually advanced by the legal regime.

The thesis determined that the legal regime which controls the conduct of a target firm's board of directors does not consistently advance the interests valued by the financial model. This mixed result is neither surprising nor controversial. It, and the means by which it was obtained, are, however, instructive.

A tentative proposal was made to bring the legal regime more fully into accord with the interests valued by the financial model and with corporate law of general application. The purpose of the thesis does not include an in-depth analysis of this or any other proposal for change. The proposal is offered to illustrate problems with the manner in which the current legal analysis deals with this issue. The proposal is necessarily incomplete and, as with any other in this area of law and finance, its implications and effects would have to be carefully considered and tested

before any steps were taken toward implementation. It does, however, highlight a point of concern.

The courts have been, and are, prepared to enter into an assessment of the actions of a board of directors within the context of a take-over bid. In particular, this assessment concerns the effect the board's actions have on the interests of shareholders. The courts' intervention is based on what is argued to be an outdated proposition: that a corporation is its shareholders. This proposition is not consistent with corporate law of general application. Nor is it, or the court's concerns for shareholders' interests, consistent with the mechanisms for protection and promotion of shareholders' interests found in the theory of the firm and in the securities regimes. By entering this area and imposing fiduciary duties on the board of directors the courts risk upsetting the operation of the financial and economic processes. In addition, the steps taken by the courts ignore the existence and competence of the securities commissions who are equipped and empowered to protect the shareholders' interests. A clearer delineation of the duties of the board of directors, and clearer enunciation of the role to be played by the securities regimes, as argued for above, would enhance the take-over process by bringing the law more into accord with the financial model. It would further improve matters by recognizing the competence, efficiency, role, and presence of the securities commis-

sions. Increased certainty in the mandate of the board of directors, the responses they can employ in a take-over, and the basis on which regulatory intervention can be expected, would reduce the uncertainty associated with take-overs and thereby enhance the operation of the capital markets.

The degree of directors' passivity should be addressed. The directors will be constrained in their actions due to the nature of their duty. The argument in the thesis is not for a complacent board, but rather for one that is motivated by a proper interpretation of its duty. It is this duty which will restrict the board's choice of actions. In practice, their position will be closely aligned to the "propaganda" response discussed by Clark in his text, *Corporate Law*.[99] This is not due to an ethic of passivity. It is due to the limited responses that are available to the board when their duty is properly analyzed. The directors can ensure that all relevant information and arguments have been presented to the market. They can go further and, for example, initiate proceedings under the securities regime. They may choose to make an application for an extension of a bid so as to encourage an auction. Their role is not to be interpreted as merely passive although their role will be less active than it is under the currently accepted analy-

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99. Clark, R.C., *Corporate Law* (Boston: Little Brown, 1986) at 571-572.

sis. They can, and must, take steps to protect corporate interests.

Much of the argument in this thesis is premised on a divergence of corporate and shareholder interests. In circumstances of perfect information, costless communication, and efficient markets, all corporate interests would be fully known, communicated, analyzed, and thereby incorporated into the share value. As such, the interests of the shareholders would be identical to those of the corporation. Communication is not, however, costless, knowledge is not perfect, and financial markets are not perfectly efficient. Divergence of interests does arise. Some of the corporate interests can be considered potential or nascent shareholder interests. In the fullness of time they will be converted from corporate to shareholder interests through the mechanisms of the market. Others, given the limitations on the market, are not likely ever to become shareholder interests.

Interests may diverge when information, known to the corporation, is not communicated to the shareholders or the markets. Due to insufficient data, the market and shareholders cannot properly assess and value corporate prospects and, accordingly, they remain corporate interests. The directors can protect these interests through adherence to the disclosure requirements of the take-over regime. Full disclosure will facilitate the recognition, evaluation, and preservation of these interests.

Management and directors may also, *bona fide*, disagree with the market's assessment of corporative initiatives. Decisions that run contrary to current business trends and are not, therefore, welcomed by the market are examples of such initiatives. For example, a firm which, in an environment of cut-backs and lay-offs, decides to undertake a significant increase in staff and services may find its share value depressed. If the appropriate, long-term value of the corporation is not recognized by the market the directors must make arguments that promote that recognition.

Corporate interests also arise as a result of the distinct, legal personality of the corporation. A corporation has certain rights and attributes that cannot be dispersed to shareholders and other claimants. The right to freedom of expression and protection from unreasonable search and seizure are two examples. These concepts have been reified and, in appropriate fact situations, they may be placed in jeopardy thereby requiring the protection of the board of directors. Even in an environment of perfect and costless communication of information the market is not likely to be able to value these interests. Due to the realities of the market and the uncertain effects of these rights on share values these interests are not fully recognized by the market. If they are to be protected, the protection must be provided at the corporate level. These

interests are, therefore, the responsibility of the board of directors.

Corporate interests can take the form of corporate attributes that lower the corporation's transaction costs. For example, a reputation for fair dealing in labour relations may be at risk if a new management team is introduced. Such a result could erode the corporation's standing with organized labour and lead to increased transaction costs. This and other hard-won advantages cannot be dispersed to shareholders. They are, therefore, within the class of interests that are to be protected by the board of directors.

Securities commissions consider shareholder interests in the context of the public interest. It is not the duty of the board of directors to consider the public interest. It is their duty to consider corporate interests. It follows that when an action adversely affects the corporation the board of directors must respond to protect the corporate interests notwithstanding the action may be in the shareholders' or public's interest. A corporate take-over, for example, may jeopardize the integrity of a trade secret. Although the shareholders will be compensated the corporation itself will have lost a valuable interest due to its inability to further exploit the secret.

Operationalizing the idea of corporate interests that are distinct from the interests of those who hold claims

against the corporation is achieved by considerations of information asymmetry, considerations of the corporation's legal status and rights, considerations of the attributes of the corporate personality that facilitate its operations, and considerations of assets that have a greater, if still vague, value to the corporation than their liquidation value to the shareholders. Operationalization is also facilitated through the consideration of *bona fide* disagreement with the market's valuation of corporate initiatives and assets. This list is not exhaustive. Many interests can and will arise as directors and their advisors become more aware of the existence and importance of these interests.

In many circumstances corporate interests and the interests of the shareholders will be identical. In such cases the directors will be serving the interests of the shareholders by serving the interests of the corporation. This result does not invalidate the actions of the directors. It is when the interests of the corporation diverge from those of the shareholders that the directors must be alive to and act to fulfil their appropriate responsibilities.

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